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TAX REFORM PROPOSALS—I

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE
NINETY-NINTH CONGRESS
FIRST SESSION

JUNE 11, 1985

(Testimony of James A. Baker)

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TAX REFORM PROPOSALS—I

TUESDAY, JUNE 11, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Dole, Roth, Chafee, Heinz, Wallop, Durenberger, Armstrong, Symms, Grassley, Long, Bentsen, Matsunaga, Moynihan, Baucus, Bradley, Mitchell, and Pryor.

[The press release announcing the hearing and the prepared written statements of Senators Dole, Roth, Chafee, Baucus, and Mitchell follow:]

CHAIRMAN PACKWOOD ANNOUNCES FINANCE TAX REFORM HEARINGS

Senator Bob Packwood (R-Oregon), Chairman of the Committee on Finance, travelling in Oregon, today announced that the Committee will begin hearings in early June on President Reagan's tax reform proposal.

"The Committee's work on the President's proposal will begin with Treasury Secretary Baker's testimony on June 11th," said the chairman of the Senate tax-writing committee, "and will involve upwards of 30 days of hearings—3 or 4 days each week the Senate is in session during the months of June, July and September."

Chairman Packwood announced the first five days of hearings, as follows:

Secretary of the Treasury James A. Baker III will present the President's tax plan to the Committee on Tuesday, June 11, 1985.

Internal Revenue Service Commissioner Roscoe Egger will appear before the Committee to testify on Wednesday, June 12, 1985.

On Thursday, June 13, 1985, the Committee will receive testimony from invited national business leaders.

On Monday, June 17th, public witnesses will testify on the impact of the tax reform proposal on people below the poverty line.

On Tuesday, June 18, 1985, witnesses invited by the Committee will discuss the general issue of whether corporations ought to pay a higher percentage of the income tax burden.

All hearings will begin at 9:30 a.m. and will be held in Room SD-215 of the Dirksen Senate Office Building.

STATEMENT OF SENATOR DOLE, FINANCE COMMITTEE HEARINGS ON MAJOR TAX REFORMS

Today the Finance Committee begins a review of the issues raised by President Reagan's proposals to overhaul our tax system. These hearings are intended to give us a better understanding of the implications of major reforms from the standpoint of tax, social, and economic policy. This is only a beginning: There are many individuals and organizations who would like to be heard on this subject, and I know Chairman Packwood will do his best to hear everyone—we need to hear as wide as possible a range of opinions and perspectives on this subject, because we are talking about fundamental changes.

I hope these hearings establish a framework to guide our deliberations on restructuring the tax system. We can do that by clearly formulating the basic options, by developing the facts and figures necessary to informed decisions, and to pinpoint the technical and practical problems that will have to be dealt with if we want to modify the tax system in a major way. I know the witnesses are prepared to help us do all of that, Secretary Baker most of all.

REAGAN PROPOSAL

Let me say that in my view, President Reagan's tax reform plan is a courageous and historic initiative that would vastly improve the federal income tax system.

There is no question taxpayers have become increasingly dissatisified with our overly complex income tax system. When I was chairman of this committee, we identified scores of tax abuses and unjustified loopholes and moved to close quite a few of them. But much, much more must be done to restore our people's belief in the fairness of the Internal Revenue Code. The President's plan is a huge advance in the direction of greater fairness for all taxpayers and greater economic efficiency.

Everyone wants greater equity in the tax code, and a simpler system, and a tax system that promotes—or at least does not inhibit—economic activity. Choosing the system that best balances each of these goals is not easy, however: and deciding how to move toward a better system may be the most difficult choice of all. There is no point in making a change unless we make a big improvement. I think President Reagan's plan is a big improvement, but we have to make sure its virtues are not eroded in the legislative process.

HOW TO PROCEED

Agreeing on a major revision of the tax system in the direction of lower rates and a broader base means a difficult period of transition to reconcile the new system with the old while safeguarding the economic interests of those who have made financial decisions based on the present system. The potential pitfalls with this approach are that it requires long-range planning and implementation, and there is the risk that the consensus behind the new system could erode during the lengthy course of implementation. That could leave us with a system no better, or even worse, than present law.

So we have a big job ahead: not just to help the President build a consensus for tax reform, but to sustain that consensus through a difficult legislative process and in the years ahead. Let there be no doubt, everyone with an interest in the tax code as it is now will be very, very busy in the months ahead.

MUCH TO BE DONE

Just outlining the policy options and procedural options makes clear how much there is to be done if we want to rebuild our tax system in a way that is fairer, simpler, and better for the economy. No system can be sustained without a strong popular consensus: Indeed, a major reason we are considering fundamental reforms is the indication of weakening consensus behind our present system, as demonstrated by the growing compliance problem. We do not want to hastily adopt a system that connot be sustained over time, either because of technical flaws or lack of popular support.

As we work for the consensus needed to support any far-reaching change in tax policy, we should remember the direction set by the rate reductions adopted in 1981 and the base-broadening and compliance measures we agreed to in 1982 and again last year. We have already moved toward lower rates and a broader base, and have put the pressure on to reexamine the tax system by indexing individual rates to end bracket creep. There does seem to be a consensus for further reduction of rates and broadening of the tax base. With the President's tremendous commitment to tax reform, that consensus should continue to grow.

THE OPENING STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

"Secretary Baker, I support the concept of tax reform very strongly and I find many things in the Administration bill highly desirable.

"But, frankly, Mr. Secretary, it will be very difficult for me to support this tax package as drafted. What you seem to have done is taken the tax burden from the ends of the economic scale and swept it to the middle. As I read your plan, you are proposing raising taxes on up to 33% of the middle class of this country, and I think that is just plain wrong. Maybe this 33% has been avoiding their fair share of taxes through abusive tax shelters or creative accounting, and if that is the case then I welcome that information. But I doubt that very much. I don't consider the state and local tax or the two-earner deduction in the same class as mango-farming partnerships.

"I simply cannot support a proposal, even cloaked in the mantle of tax reform, which raises taxes on so many middle income families.

"Further, this proposal does not go nearly far enough to remove the worst bias in our tax code—the double taxation of savings. Without an increasing pool of savings, this country is going to fall by the wayside in the face of international competition. But the plan seems to virtually ignore this economic fact of life.

"Congress can fix these problems with the Administration plan by identifying a new revenue source and using that source to lower marginal rates, to remove the double taxation on personal savings, and for other purposes which have the net result of lowering taxes on middle income people.

"That new revenue source should be a Business Transfer Tax. As you know, I have a bill, S. 1102, that would impose such a tax on business, and allow the tax to be credited against FICA. That plan at a 10% rate will, I understand, raise $70 billion in 1968, $37 billion from domestic industry and $33 billion from imports. With that revenue, we could take the President's plan and dramatically lower marginal rates, to say 15/20/30 percent for the same brackets, and still have about $30 billion left over per year for other worthwhile reforms on both the individual and business side. I intend to encourage this committee to take this kind of approach.

"In short, Mr. Secretary, unless we, working together, can remedy the basic problems of this plan—namely, the increase in taxes for millions of middle income Americans and the lack of pro-savings initiatives—then I think this plan should be sent back to the drawing board."

STATEMENT BY SENATOR JOHN H. CHAFEE, BEFORE THE SENATE FINANCE COMMITTEE

First, I would like to thank our distinguished Chairman, Senator Packwood for begining these hearings on tax reform so promptly and for planing such and exhaustive examination of the issues. Second, I would like to congratulate the President for taking the lead on tax reform. Tax reform is going to be very difficult and we are going to need the President's leadership and support. It's clear he is going to do all he can to have this program enacted.

I am enthusiastic about tax reform. We need to address the growing lack of respect for our tax system, and the only way to do this is through fundamental reform which assures all our citizens that the tax system is fair. It is fairness, not just simplicity that should be the ultimate goal of tax reform.

As we begin the hearing and debate process, we are going to find it difficult to keep an open mind and not leap to the defense of every tax incentive we have traditionally supported. Of course each of the tax deductions, credits and exemptions has supporters. Each one of these items was placed in the tax code for a reason, but the time has come to clean house and re-evaluate.

The ordinary citizen does not enjoy the benefits of most of these special tax incentives no matter how wonderful they may be for a particular industry. The ordinary citizen does not itemize. Two-thirds of our citizens file the short form currently. Under the President's proposal even fewer taxpayers will be itemizing.

As this tax reform debate continues, I think we must remember that anytime we say, "yes" to keeping a special tax break in the code, we are saying, "No, we can not lower your tax rates." to at least two-thirds of the population. Additionally, each time we say "yes" to one more incentive, it becomes that much harder to resist the next proposal.

Working within the constraints of keeping the individual and corporate rates low and having this legislation revenue neutral, we are entitled to examine whether the incentives in the bill are the right ones. For example, why does Treasury tax the first $300 of fringe benefits, but none of the balance? Is it fair to hit equally those who receive the least and those who receive the most?

Also, I believe we must carefully review what we are doing to the international competitive position of our manufacturing industries when we abolish the Investment Tax Credit and change the depreciation schedules.

STATEMENT BY SENATOR MAX BAUCUS

Thank you Mr. Chairman.

Mr. Secretary, I want to complement you and President Reagan.

We all know that the tax code is a mess. It's complicated and unfair, and needs to be reformed.

Your proposal points in the right direction.

Although it doesn't go far enough, it will begin to restore some of the American people's lost confidence in our system of collecting federal revenue.

Nevertheless, I have a nagging feeling that we're missing a larger, more important issue.

A few years ago, our country was unquestionably the most productive in the world. We produced the autos, the steel, the TV sets, the agricultural products, and the fancy high technology.

Today, that's no longer true.

We import over one-quarter of our autos and steel. We import over *half* of our TVs. Our agricultural exports are declining. And our high-tech products face fierce new competition.

Look at the statistics:

Our trade deficit is $130 billion and rising.

We'll have to borrow $467 billion over the next three years to finance this deficit.

Forty cents of every individual income tax dollar goes to pay just the interest on the debt;

For the first time since World War I, we have become a debtor nation. At the rate we're going, our foreign debt will soon exceed that of Brazil, Mexico, and Argentina combined.

Our personal savings rate is only 4%, the lowest of any industrialized country, half that of the rest of the world;

Our productivity growth rate is declining, and is now half that of Germany, one-fifth that of France, and one-sixth that of Japan.

These are the symptoms of a major problem: the American economic ship is off-course.

As we debate this summer and fall about who gets tax breaks and who doesn't, it will be like arguing over who gets deck chairs in the sun and who gets deck chairs in the shade—when we should be deciding the ship's course.

Unless we dramatically change our course, we will lose the standard of living, the opportunities, and the economic power that have made us great.

Tax reform is just part of the productivity equation. Other important parts are fiscal policy and international trade policy.

It would be easy for tax reform to become a kind of economic panacea, distracting attention from the budget and trade. We can't afford to let that happen, and I hope that both the Administration and this Committee devote as much energy to these issues as to all these tax hearings.

At the same time, we cannot ignore the effect federal tax policy has on our economy.

Our challenge

The challenge we face this year and next is not just to reform the tax code.

Our challenge is to do something about this nation's ability to compete in the world economy.

And our challenge in this committee is to shape a tax policy that helps Americans accomplish that goal.

The President has adopted one theory in designing his tax plan. He says we should reduce government intervention in the economy, to unleash the productive forces of the private marketplace.

It sounds good. It looks good on paper.

But in the real world, I don't believe it works.

It overlooks a longstanding tension in American life. It's said that all American political thinking can be boiled down to two sentences: "get the government off by back," and "there ought to be a law about that."

American history is rife with lore about the individual, the loner. But our railroads, farms, factories, and irrigation systems weren't built by loners. They were built by a combination of individual and cooperative action.

I say this not to lessen the importance of what the President is trying to do, or what Secretary Baker is here to talk about.

Rather, I say this to stress that we should aim from something more than an antiseptic tax policy.

I believe we should aim higher.

We must ask how any tax proposal affects the American economy: our productivity, our rate of investment, and our competitiveness.

It is answer to these questions that I hope to get at these hearings.

Finally, Mr. Chairman, tax reform is an ambitious undertaking. Its success depends on cooperation and trust: between the White House and Congress; between Democrats and Republicans; between American citizens and their government.

Without that trust, this effort will fail. And without that trust the larger effort will fail.

We cannot afford to fail. The stakes are too high.

Mr. Chairman, Mr. Secretary, I look forward to working with you both in this effort.

STATEMENT OF SENATOR GEORGE MITCHELL ON TAX REFORM HEARINGS

I want to welcome Secretary Baker before the Committee this morning. Over the last several months, probably no other person in Washington has put more time into this effort to reform our federal income tax system. I commend him for his and the President's efforts in support of tax reform.

I strongly support the effort to fundamentally reform our federal system of taxation and it is my hope that the Finance Committee and Congress can proceed expeditiously with consideration of tax reform legislation. I realize, however, that we have before us an imperfect document and one that in my opinion is in need of several changes. The Treasury Department and the White House have been meeting with various interest groups over the last few months and have accepted many of their demands. As a result, the President's tax reform plan is but a shadow of the plan the Treasury Department originally proposed last November.

That will make our task all the more difficult in Congress. It is my desire that we not further retreat from true tax reform, but that we go beyond—much beyond—the President in crafting a package that closes loopholes, simplifies the federal tax system, and provides for equity across income groups.

We have a tremendous task before us and I look forward to working with Secretary Baker in the months ahead.

The **CHAIRMAN**. Today we start the first of what I hope is going to be a long and challenging process of reviewing the administration's 1985 tax proposals, along with suggestions from others, including members of this committee, as to how that proposal might be changed or, I think in their judgment, improved. That remains to be seen.

This is the first of a series of hearings. We have about 30 scheduled through June, July, and September, and it is my intention, if we can get a bill from the House by no later than the 15th of October, to finish a bill in the Senate; have it done with the conference and to the President by the end of the year. And I think we can do that if we have a bill here and if the majority leader is willing to keep us in session. I know his plans were to leave by the 1st of November, but if he were to keep us in session through the Christmas holidays, I think we could finish the bill.

Senator **DOLE**. Bye-bye. [Laughter.]

The **CHAIRMAN**. I don't think we've ever seen a more extensive set of tax proposals than the one we have before us today. These proposals, in one way or another, affect every individual, every family, every business, and every corporation in the country. They affect the health and the future of our country and our ability to compete overseas. They also affect many of the social goals and policies that are fundamental to this country. I'll be examining the proposals with several basic questions in mind. First and foremost, are the proposals fair? Do they fairly carry out the important economic and social goals of this country?

Second, will the proposals continue and, indeed, enhance our economic recovery, and what effect will they have on employment, interest rates, and our competitiveness abroad?

Third, will the proposals improve our system of taxation generally? Will they enhance compliance, and will they simplify the tax system for all Americans? Will they encourage greater respect for the tax system?

And, last, what is the revenue impact of the proposal? Are they neutral or do they lose or gain revenue?

It's fitting that we should have as first witness Secretary James Baker who will present the President's proposals. And I welcome him here today.

I might ask if there are other opening statements.

Senator Long.

Senator **Long**. No opening statement, Mr. Chairman.

The **Chairman**. Senator Dole.

Senator **Dole**. I have a statement which I would like to make part of the record. I'm not certain I'll be here at Christmas so I want to put my statement in today. [Laughter.]

But let me indicate this: That we are prepared to do everything we can on the Senate side to reach a satisfactory result. Much depends on how quickly the House moves If they would get the bill to us in October, I would guess that it would take 3 or 4 weeks on the Senate floor even after extensive hearings. So I'm not ready to predict that we will pass the tax bill this year, but our calendar right now is fairly clean. If we had it up next week, we could probably handle it.

But there are a lot of questions that have to be answered. I think once the initial glow has faded, there are a number of very difficult questions this committee is going to have to deal with. And we've had a record of reform in this committee starting with the 1982 tax bill; again in 1984. And we've been able to put together for the most part a bipartisan effort in the committee to close loopholes and to do some good things in the Tax Code.

This effort by the President and by Secretary Baker is historic. It's a massive change in the code. Everyone supports the concept. I think there are a number of issues that we need to address specifically, but I would indicate, with the chairman's eagerness to complete action this year, certainly we will cooperate with the chairman and everyone else on the committee. We are looking forward to this hearing and the 30 other sessions you have scheduled.

The **Chairman**. Other opening statements?

Senator **Chafee**. Well, Mr. Chairman, I just want to say that I think it is splendid that you have scheduled these extensive hearings, and, of course, that the President has given such strong support to the overall program. It's one that I'm for. I know everybody will say in generalities they are for tax reform, but then we get to the specifics. But I'm for the basic overall program, as presented, by the Secretary. I think there are some questions we are going to have, questions dealing with the fringe benefits, the way he arrived at the proposal. I'm not quite sure why everybody gets taxed on the first $300 of the fringe benefits. Those who receive the least and those who receive the most are taxed the same.

I think also we've got to look at the situation for our manufacturers. No longer are we looking at our manufacturers competing one manufacturer versus another in the United States. We are thinking of our manufacturers competing against the world. Are they going to be able to have this successful competition with the removal of the ITC and the changes in depreciation rates?

I do think it's important that every time we say yes to some tax break we are in a round-about way saying no, the rates can't be as low as we expected. Every time we say yes to some tax break, we are opening the doors to another coming in.

So there are some real challenges presented to us. I look forward to these hearings

You say there are going to be 30 of them?

The CHAIRMAN. We have about 30 scheduled. What I have done, Senator Chafee, is schedule them in the hopes of being able to go from 9:30 to 12:30 each day and not run into the afternoon. I've not scheduled witnesses in the afternoon My hunch is from time to time we will lop over into the afternoon. But we have about 30 days of hearings scheduled between now and the end of September. And I don't expect we will have the bill from the House before that time so we will have time to do those hearings.

Senator CHAFEE. Well, we may flag around hearing 27 or something, but we will try and go that last mile with you.

The CHAIRMAN. Other opening statements? Senator Moynihan, Senator Baucus.

Senator MOYNIHAN. Mr. Chairman, thank you for this bright beginning and for your willingness to take a better part of the year of the committee's work on this matter. We recall that you got your first tax bill in and out in 111 minutes and 30 seconds.

In the view of some of the members of the committee—and I think this would be the case in nearly anyone's view—the single most significant item in this plan is the proposal to eliminate the deduction for State and local taxes, as has been remitted since the income tax was established in 1913. The elimination of this deduction brings in the largest single bit of revenue raised in order to have lower marginal rates.

And I would hope that as the witnesses are assembled those who view this to be the most important change in federalism in this century would have a good opportunity to be heard. I'm sure you will do that. And I want to thank you in advance.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Secretary, as we debate this bill through the summer months, I first want to compliment you on the efforts that you and the administration have taken to try to take the first step toward simplification, reform; try to encourage the group, because, obviously, the American people think the Tax Code is a mess, and they are right. The Tax Code is a mess.

I, however, have this nagging feeling that during the rest of the summer, that to a very large degree we are going to be missing a larger, bigger point—the American competitive position today—slipping, declining—and what our competitive position might be next year or the next 2 or 3 years that follow. I'm very concerned, frankly, that we are going to be arguing about who gets what tax breaks and who doesn't get tax breaks. It's like rearranging the deck chairs on a ship. And rather we should be addressing the question of what direction are American economic ships going.

We were once the envy of the world. We produced all the autos practically. We produced TV sets. We were in agricultural growth. Semiconductors. The electronics industry. You name it. And, obviously, that position in America has declined radically, significantly in the last several years. And all the trends are in the wrong direction.

Our trade imbalance is roughly $130 billion and rising. By 2 or 3 or 4 years, our debt that is held by foreigners is going to exceed the foreign debt that's attributed to Argentina, Brazil, and Mexico combined. And, obviously, we can't let that happen. But that's where the trend line is going. That's what is happening.

Our U.S. budget deficit is causing significant problems. Our unemployment is still very high—7.3. And I'm just hoping the Secretary, that the administration will be very open during this summer and the fall and into next year, however long it takes to get this major bill passed, to look again at how we increase our productivity in America. I think that it's good to achieve the goal of simplicity and equity of distribution and so forth. But I think we can't afford to wait until 1 year from now, 2 years from now, 3 years from now to try to find some very major, dramatic ways to help increase the American productivity.

Now, obviously, all the answers aren't in the Tax Code. There are other areas in which we can help increase our productivity and our competitive position. But a lot of them still are in the Tax Code. And I hope the administration is very open to all of that.

This leads me to my next point; namely, that I hope the administration bends over backward, as I hope the Congress does, to achieve cooperation. We are only going to solve these basic problems if the White House and the Congress bury their differences, their constitutional differences, as much as possible and come together. And along with that, we have to bury the partisanship that I think is too strong in this country. That is, that both political parties have to approach this much more in a bipartisan, nonpartisan basis so that we can achieve our mutual goals. Otherwise, this effort is going to fracture, divide. It's going to not be successful.

And I make a very urgent plea to you, Mr. Secretary, that in addition to following your intent, which I think is a step in the right direction, to more importantly keep the lines of communication open, bend over backward even more, as I hope we do, to achieve a mutual solution that addresses our declining competitive position of our country in the world.

The CHAIRMAN. Mr. Secretary, we have your full statement.

Senator HEINZ. Mr. Chairman.

The CHAIRMAN. Excuse me. Senator Heinz.

Senator HEINZ. I just wanted to comment, if I may. I welcome Secretary Baker, and join in commending you, Mr. Chairman, in moving ahead.

I just hope, Mr. Secretary, Mr. Chairman, that as we focus, as indeed our constituents want us to do no doubt, on individual issues in the Tax Code—whether it be State and local taxes or other provisions of concern—that we will not in our passion for looking at these very hot items overlook the big picture on tax reform. The big picture is certainly trying to make this Tax Code fairer, and if possible, simpler, although I suspect they are natural enemies to each other.

But even more than that, when all this is done, I hope that our product creates better incentives than we have today for economic growth. And I hope that the committee, Mr. Chairman, will look at such issues as to whether this Tax Code will do such things as bring about a lowering of interest rates and just as important, probably more so because without it you can't achieve a lowering of interest rates, is whether or not it will do a better job than the existing Tax Code of emphasizing and giving incentives for savings, both individual and corporate. Without those savings, there won't be the pool of investment capital to create jobs. And without those jobs, there won't be growth.

So I would just hope that as we look at all these very important individual items that we don't lose sight of the big picture here. And the big picture is, if possible, to try to correct the current imbalance in our Tax Code toward consumption and try to tilt it back away from consumption and more toward savings and the investment and job creation which I think we all want.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

I have a statement which I won't read, but I would like to make two or three observations.

First of all, I do want to say that I strongly support the concept of tax reform. And I congratulate the administration for the strong position they are taking on this issue. But I am deeply concerned about two aspects of the administration's proposal.

First of all, as I understand it, at least at this stage, it seems to soak the middleclass. If I understand it correctly, what has been done is to take the tax burden from the ends of the economic scale and slip it to the middle. And I think it's important that we correct that. If I'm wrong, I'll be much interested in understanding why this is not the case.

Second, Mr. Chairman, it seems to me a principal purpose of the tax reform has to be to create an environment of growth. Key to that, I think, is to promote savings, and I don't see this administration's proposal doing much, if anything, about the double taxation of savings. I will be proposing to the committee in its deliberations that we seek a new source of revenue, a business transfer tax, at perhaps, 10 percent. This tax would raise $70 billion. We could use half of that to lower the brackets from 15, 20, 30 percent for the same brackets and still have about $30 billion left over per year to reform other individual and business items.

So during the course of questioning, I will want to question Mr. Secretary about these proposals, but I am pleased, Mr. Chairman, that you are holding these hearings today.

The CHAIRMAN. Are there other opening statements?

Senator SYMMS. Mr. Chairman.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Mr. Chairman, I will be very brief. But I would just like to say as one member of the committee that I think this worshipping at the shrine of revenue neutrality, it may end up being the demise of the noble intentions that so many people here have on tax reform. And if we really want to have tax simplification, I think we need to be even much more aggressive than the package that the administration is starting out with. And then also we have to recognize that the static numbers that Treasury uses are not going to reflect what will happen in the future years. And I think if we worship the shrine of revenue neutrality, we are going to make it awful difficult to be able to ever achieve anything that will be an improvement over our current Tax Code. And I think we are getting set up to be in a trap here that will be much more difficult than the members may realize at this point.

The **Chairman**. Further statements?

[No response.]

The **Chairman**. If not, Mr. Secretary, the floor is yours.

STATEMENT OF HON. JAMES A. BAKER III, SECRETARY OF THE TREASURY, WASHINGTON, DC

Secretary **Baker**. Thank you very much, Mr. Chairman. And I thank you as well for the invitation to appear here today to discuss fundamental tax reform.

With your permission, Mr. Chairman, I would like to submit for the record not only my full testimony, but also the text of the President's May 28 address to the Nation, and a copy of the President's tax proposals to the Congress for fairness, growth, and simplicity.

[The prepared statement of Secretary Baker and a letter from Senator Durenberger follow:]

TESTIMONY OF THE HONORABLE
JAMES A. BAKER, III
SECRETARY OF THE TREASURY
BEFORE THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I thank you for your kind invitation to appear here today to discuss tax reform. With the Committee's permission, Mr. Chairman, I would like to submit for the record not only my full testimony but also the text of the President's May 28 address to the nation and a copy of the President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity.

I last appeared before this Committee on the 23rd of January in connection with my nomination by the President to be Secretary of the Treasury. Since then I have spent a great deal of time consulting with your Chairman and with members -- from both sides of the table -- as we developed the President's proposals. Before going any further, I would like to thank each of you for sharing your insights with us. Although we may not have embraced every one of your ideas, we did learn and benefit a great deal from our discussions with you.

On May 28th, the President announced his proposals for sweeping changes in the federal income tax structure. In his address to the nation, he emphasized the importance of this to all of us when he said:

> "No other issue goes so directly to the heart of our economic life; no other issue will have more lasting impact on the well-being of your families and your future."

I want to stress that these proposals are the President's. He reviewed our recommendations, considered the options, and made all of the final decisions. The President stands squarely behind these proposals. As you know, since they were announced, the President has been using his very commanding power of persuasion to communicate the benefits of these proposals to the American people. To date, we have been greatly encouraged by the responses.

In his State of the Union Address earlier this year, the President enumerated the following tax reform goals:

- o Tax reform should not be a tax increase in disguise;
- o Personal tax rates should be reduced by removing many preferences, with a top rate no higher than 35 percent;
- o Corporate tax rates should be reduced while maintaining incentives for capital formation;
- o Individuals with incomes at or near the poverty level should be exempt from income tax; and
- o The home mortgage interest deduction should not be jeopardized.

Today, I am prepared to discuss with you the Administration's specific proposals for remodeling our tax structure to achieve those goals.

Reform proposals, however, should also conform to certain basic principles of taxation which this Administration has supported consistently. The first of these, low rates of tax, is essential in order to further stimulate work effort, to encourage savings and investment, to reward invention and innovation, and to discourage unproductive tax shelters. Low tax rates, which can be obtained only if the taxable income base is broadened, are especially important because, to the extent a certain source or use of income remains favored by the tax law, the distortion left by this bias will be kept small.

Second, not only must we not allow tax reform to be a tax increase in disguise, as the President has warned, but also we must not let tax revenues decline and worsen the deficit. In other words, tax reform must be revenue neutral and should be judged on it's own merits. This is a particularly sound principle because it imposes discipline upon those who would like to retain special tax concessions found in current law. In a revenue neutral setting, the price of retaining any special tax benefit is higher tax rates generally.

Some have suggested that we have been too conservative in our insistence on revenue neutrality. They claim that our view of the economy is static because we fail to take credit for additional tax revenues from increased growth and favorable behavioral responses that will result from tax reform. This line of argument is only partly correct; and even then the disagreement is over political judgment and not economic principles.

It is standard practice at Treasury to assume that taxpayers' behavior will be affected by any tax proposals. Indeed, many of the figures in our year-by-year analysis of the revenue impact of the President's plan over the next five years -- Appendix C to the President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity -- would be different if we had not made these assumptions.

We have, however, decided not to include the growth effects of reform in measuring revenue neutrality. In the long run, by 1995, we expect our proposals to improve real GNP, but we have not included this additional growth in our revenue estimates. We have used identical macro-economic assumptions in calculating current law revenues and revenues under the President's proposals. We realize this is a conservative approach but we also recognize that this decision makes us immune to charges that we cooked the numbers to pay for a tax reduction with bogus revenues from an overly-optimistic forecast. I am comfortable associating myself with the President's observation that if it is revenue neutral on a static basis, it will end up actually providing more revenues for the simple reason that the base of the economy will be expanded.

Fairness for families is the third principle we have established for tax reform. As the President has said, fairness for families means that those with poverty-level incomes should not have to pay any income tax. It also means that the value of the personal exemption must be restored, that the earned income credit for the working poor must be strengthened and indexed for inflation, and that the discrimination against spouses working in the home and wanting to save through an IRA must be eliminated.

A fourth principle for tax reform is economic neutrality to stimulate growth. Economic neutrality for growth requires that all income be taxed uniformly and consistently by being subject to the same rules of taxation. In a simple world, this calls for eliminating all deductions, exemptions, and credits that favor certain sources or uses of income. In a more practical setting this means that some incentives will be provided through the tax code. The tax system, however, should not be used to favor one person, one investment, one business, or one use of income over any other.

Simplicity is the fifth principle we have identified as important. Discussions with ordinary taxpayers reveal that the complexity of our tax laws contributes as much as any other factor to the perception that the system is unfair. Most taxpayers feel that they are paying more than their fair share of the federal income tax and that the system is so difficult to comprehend that there is nothing they can do about it. Others who are more sophisticated or who can afford to hire clever advisors use complex provisions to reduce their tax bills.

The last principle guiding our design of tax reform is the need for a fair and orderly transition. We have recognized all along that fundamental reform of the scope being recommended by the President could result in serious short-term economic dislocations, unless planned carefully. This concern is not a valid reason to avoid undertaking reforms. It is, however, a good reason to take care that the transition from current law to proposed law is as smooth as is practicable. If we would permit abrupt shifts in tax burdens and in the allocation of economic resources to create substantial hardships for individual taxpayers or for isolated sectors of the economy, reform would be impossible and unwise.

We recognize, of course, that it is the prerogative of the tax-writing committees of Congress to design appropriate transition rules and we look forward to working with this Committee to develop transition rules that you determine will be necessary to implement the President's proposals in a manner that will minimize unanticipated effects.

The Need For Fundamental Tax Reform

The current body of Federal tax law, commonly identified as the 1954 Code, is now some thirty years old. Over the span of three decades the law has been tinkered with so often and weighed down by so many amendments that its original drafters may have difficulty recognizing it. Although we are not recommending outright repeal of the current code, we are recommending that instead of more tinkering, we should make some very basic, fundamental changes to remodel the code. These changes will eliminate the need for some complicated rules; they will help restore free-market principles to economic decision-making; and they will streamline tax calculations for many individuals.

The average taxpayer has become convinced that others benefit from this growing complexity and that he or she does not. He or she understands very well that as long as the tax laws permit others to shelter income and thereby avoid paying a fair share of tax, then he or she must make up the difference by paying a greater share. It is not possible to separate the fairness issue, the neutrality issue, and the simplicity issue. Every new amendment to fine-tune this thirty-year old tax code serves only to worsen the public's perception of fairness. The time is right for starting anew with the fresh approach that fundamental reform offers.

Let us not, however, underestimate the task. The remodeling of our tax laws that the President has recommended is an undertaking not to be lightly considered. Although the process leading to enactment of fundamental tax reform legislation is started, and, with full bipartisan cooperation, can be completed this year, the task will be arduous and time-consuming.

We cannot expect to succeed unless we all are convinced that there is a clear and compelling need for reform.

We have only to listen to the ordinary taxpayer to learn that such a need does exist. Taxpayers across the country are dissatisfied with the current tax system because they believe it is unfair; they know it is too complicated; and they suspect that it impedes growth because it discourages risk taking and innovation and encourages wasteful tax shelter investments instead of rewarding honest toil.

High Income Taxpayers

People are justifiably outraged by stories of those with high incomes paying little or no income tax. We thought it was important to discover whether such horror cases are common or rare. To find out, we examined tax returns of individuals and families with incomes of $250,000 or more in 1983. Ranked by income, these represent roughly the top one-fourth of one percent of all households in the United States. We selected tax returns on the basis of their positive sources of income only, that is, income before deducting any offsetting losses. Our findings may -- or may not -- surprise you.

- Thirty thousand of these high-income families, representing 11 percent of this group, paid taxes amounting to less than 5 percent of their positive-source income.

- Fewer than half of all the high income tax returns we examined reported tax liabilities that most people would consider to be a fair share at this income level -- 20 percent or more of positive-source income.

- Among the very highest incomes -- those with positive-source incomes greater than $2 million in 1983 -- only 37 percent paid as much as 20 percent of positive-source income in tax, and 11 percent paid a tax rate that was lower than 5 percent.

Other evidence of unfairness that troubles the average taxpayer is the knowledge that two individuals or two families with the same income and the same ability to pay tax frequently pay very different amounts of tax because they derive their income from different sources or they spend their income for different purposes. Examples are all too common:

- Individuals who spend their incomes on tax-preferred consumption, such as seminars held aboard cruise ships, pay less tax than others with equal incomes who save or who consume unfavored goods and services.

- People who make leveraged investments in depreciable property, sometimes without personal liability on the debts, generate up-front deductions bigger than amounts placed at risk, and pay lower rates of tax than others with equally large earnings who do not invest in tax shelters.

- Major corporations, for example those using accounting techniques to accelerate deductions and defer income, sometimes pay markedly lower rates of tax on their vast incomes than the average blue collar and white collar employee working for those corporations pays on his or her income.

Complexity and Inefficiency

There is also a pervasive feeling that complexity breeds unfairness, that the tax system must be unfair because it is so complex. Most taxpayers feel that they have to pay more than their fair share of tax because complexities in the system give unwarranted benefits to others. According to a recent survey commissioned by the Internal Revenue Service, fully 80 percent of all taxpayers believe the present tax system benefits the rich and is unfair to the ordinary working man or woman, and a majority of the respondents felt that the system is too complicated.

The plain truth is that the people are right. The system is too complex and is unfair. Families and individuals with the same income now pay widely differing amounts of tax and those with very different incomes quite often pay the same rate of tax. The American people don't want a tax system that works this way. It is disturbing to the deep-rooted American sense of fair play. They also don't want a tax system that is so complex that half of them feel they must pay professionals just to help them figure what they owe the IRS. Above all, they don't want a tax system that, although nominally progressive, favors the wealthy who are able to take unfair advantage of the complexities of the law.

A less obvious consequence of the seemingly capricious way in which some income is taxed heavily while other income is taxed lightly or not at all is the economic inefficiency caused by interference with the market allocation of resources. Investors and businesses, both large and small -- but especially those paying high rates of tax -- are beginning to recognize what economists have been saying all along: the flow of capital into low-taxed sectors of the economy is artificially high and capital investment in high-taxed sectors is artificially low. As a result, capital is misallocated from more productive to less productive investments.

No matter how well intentioned the original reasons for these built-in biases, their existence influences not only the amount of goods and services produced in each sector of the economy, but also the way businesses are organized and financed, and the way capital is raised and employed in the production process. The most insidious aspect of this is that by interfering with the free market, we are misallocating resources so that growth is retarded and the economy fails to achieve its full potential.

The President's Tax Proposals

The President has responded to the demands of the American taxpayers with a comprehensive set of tax reform proposals designed for fairness, growth, and simplicity. These proposals do not represent yet another attempt to tinker with current law. Instead they are intended to remodel current law.

Mr. Chairman, this morning I would like to discuss the most important aspects of our plan. A complete and detailed description of each proposal can be found in the report which the President has transmitted to the Congress.

Marginal Tax Rates

The President proposes to reduce individual income tax rates by replacing the current schedule of 14 marginal tax rates (15 for single returns), ranging from 11 percent to 50 percent, with a simple 3-bracket system having rates of 15, 25, and 35 percent. These marginal tax rate reductions complete the work begun in 1981, when we reduced marginal tax rates by almost 25 percent. Approximately 69 percent of all taxable returns will pay the 15 percent marginal rate of tax, 28 percent will pay the 25 percent bracket rate, and only 3 percent will pay the 35 percent top rate.

When President Reagan was elected in 1980, marginal tax rates ran as high as 70 percent. Now the maximum rate will be exactly half as high. In 1981 our critics argued that reducing tax rates 25 percent across-the-board would have devastating effects on the economy, making it impossible to bring inflation under control and crowding out investment. Instead, we have reduced inflation by two-thirds, from over 12 percent to 4 percent. In the last two and one-half years we have seen employment rise by nearly 8 million, or 6.3 million above the previous peak in 1981. We have seen real growth last year at its highest rate since 1951. We have seen 30 straight months of economic expansion. We have seen a greater recovery in capital spending than for any prior postwar recovery period. And, we have seen the prime rate drop to its lowest level in over 6 years.

It seems to me that back in 1981 we must have done something right. The American worker and the American businessman are telling us better with their actions than any speech writer or politician could do with predictions and promises. What they are telling us, reflected in those statistics I just cited, is that incentives do work. Lower tax rates do encourage hard work and savings. Lower tax rates do make it more worthwhile for the entrepreneur and the investor to innovate and take risks. Lower tax rates do have a less distorting influence on economic decisions -- even under a flawed tax structure that grants favors for certain sources and uses of income -- because the rewards for bucking free-market allocations of resources are small.

Like the 1981 across-the-board rate cuts, the President's plan for a straight-forward three-rate structure capped at 35 percent is pro-taxpayer primarily because it is pro-growth. What is good for the economy is necessarily good for the American taxpayer because higher productivity means higher real incomes and a better standard of living for all.

Fairness to Families

The President calls this proposal to remodel the tax laws a pro-family proposal. It is.

We are living in a pro-family society and any social or economic policy that does not recognize the importance of the American family is doomed to failure. Families comprise the basic structure of our vast middle class and it is the middle class family that bears the bulk of the tax burden. The poor are below the income tax threshold and the rich, even though they may pay sizeable tax bills, bear a small share of the total tax burden because they are so few in number.

Middle class families will benefit directly from reduced marginal tax rates. Just as important, they will take comfort in the fact that the highest rate they will ever face is just 35 percent. It is an integral part of the American dream to look forward to the day when an investment in human capital -- the college education -- or an investment in physical capital -- the new business venture -- may someday yield a big payoff. It is satisfying to know that when that day comes the government will never again be in a position to take more than 35 cents of every dollar earned.

By throwing out many special deductions, exemptions, and credits that benefit relatively few individuals, we have been able to abandon high tax rates for the benefit of all taxpayers. We are not, however, abandoning features of current law that are justified, make good sense, and provide widespread family benefits. Instead, we are seeking to strengthen such provisions.

For example, we propose raising the value of the personal exemption to almost twice its current level and we recommend expanding the income bracket to which a zero rate of tax applies. The per capita personal exemption would be raised in 1986 from $1,080 to $2,000 and the zero bracket amount would be raised from $3,670 to $4,000 for all married taxpayers filing joint returns and from $2,480 to $3,600 for families headed by one parent.

Taken together, these proposals guarantee that families living in poverty and families whose incomes are near the poverty level will no longer be required to pay federal income tax. For families somewhat better off, this means that the amount of income that can be received tax free is substantially raised. For instance, under the President's plan a family of four will pay no tax on the first $12,000 of income received, whereas they could begin paying tax with less than $8,000 of income under current law. Indeed, if the $12,000 consists entirely of earnings, this family of four will actually receive an earned income credit refund of $200, even though no tax would have been paid.

To help low income families with dependents, the President proposes raising the earned income tax credit and indexing it for inflation. Even though $1.8 billion worth of these credits was claimed on individual income tax returns in 1983, the latest year for which data are available, the credit is no longer adequate to provide a general work incentive and to offset payroll taxes levied on low income workers. The changes recommended by the President will raise the maximum credit to an indexed $700 from an unindexed $550 current-law cap.

Itemized Deductions

The right to itemize certain expenses and deduct them from income subject to tax is a longstanding feature of our income tax but one that can generate inequity. In our review of currently deductible expenses, we carefully evaluated the relative merits of each deduction against the cost -- in terms of higher tax rates, perceived unfairness, or administrative complexity. The benefits of low rates of tax are so great that there must be a truly compelling reason to retain preferential tax treatment for any use of income.

We propose repealing the deductions for state and local taxes. Only one-third of all taxpayers itemize deductions and this group includes most high-income families and very few low-income families. As a result, the cost of a family's state and local tax burden that is borne by the Federal government increases as the family's marginal tax rate increase. Thus, the deduction can convert a state or local tax that is designed to be proportional into one that is regressive.

We propose retaining deductions for home mortgage interest on a principal residence, charitable contributions, medical expenses, and casualty losses.

And, we propose limiting deductions for still other expenses. Interest other than mortgage interest on a principal residence will be limited to investment income plus $5,000, and miscellaneous expenses such as other investment expenses, union dues, tax return preparation fees, certain educational expenses, and unreimbursed employee business expenses will be deductible only to the extent that, together, they exceed a 1-percent-of-income floor. For most families, the loss of these repealed or scaled-back deductions will be more than offset by reduced tax rates and increased levels of the personal exemption and the zero bracket amount.

Officials from states and localities that levy high rates of tax have been outspoken in their condemnation of our proposed elimination of deductions for state and local taxes. They argue that repeal of the deduction will be unfair to citizens of high-tax states, that repeal will constitute a tax on a tax, that repeal will require massive cutbacks in public services supplied by state and local governments, and that taxpayers in some states will face huge tax increases.

Repeal appears unfair to those speaking on behalf of the high-tax jurisdictions only because current law is so biased in their favor. In truth, repeal will restore fairness among states and localities and, within jurisdictions, among itemizers and non-itemizers.

The arguments advanced by the high-tax states are not persuasive for several reasons. First, since two-thirds of all taxpayers do not itemize their deductions, the deduction is a subsidy for those few who do itemize. Second, since there are 35 states with relatively low tax rates, the deduction is a subsidy for those living in the few high-tax states. Third, since those that do itemize are concentrated in the high income brackets, the deduction is a subsidy directed at a relatively small number of high income taxpayers. Fourth, because so many states base their income taxes on Federal tax concepts and definitions, base broadening at the Federal level will produce an opportunity for revenue gain for the conforming states. This should alleviate any concern that these states will be forced to cut back on services financed by state income taxes.

Last, even families living in high-tax states -- those states in which the per capita tax savings from deductibility exceeds the average for the country as a whole -- will not suffer tax increases if their incomes are at the median for their state.

The attached table shows that the median income family living in each of the 15 high-tax states (plus the District of Columbia) and currently itemizing deductions will realize a tax cut under the President's proposals. Median income non-itemizers and itemizers living in the other 35 lower-tax states will have even larger tax reductions.

With respect to charitable contributions, we find the arguments in favor of retaining the itemized deduction to outweigh those against retention. This Administration has tried very hard to establish the notion that Uncle Sam cannot always be looked upon as the provider of last resort for those in need, whether they be businesses, cultural institutions, or needy individuals. Help must come from the private sector, and not always from the public sector. In keeping with this idea, however, government should encourage private sector initiatives. Consequently, we recommend keeping the itemized deduction for charitable contributions. However, the deduction for charitable contributions made by those who do not otherwise itemize deductible expenses would be repealed one year ahead of its scheduled expiration because its cost in terms of forgone tax revenue and compliance cannot be justified by any evidence of induced giving.

The deductibility of interest expense associated with indebtedness on a principal residence has been retained under our proposal because of the central importance of home ownership to values cherished by the American family. The deduction of other interest expenses, including interest on debt incurred for investments as well as for consumption, will be limited to $5,000 plus investment income. Although the vast majority of families will never be affected by this latter limitation, it will prevent taxpayers from deducting substantial tax shelter interest expense from income that would otherwise be subject to current tax.

A recognition that a spouse working at home performs valuable service to the family is long overdue in our tax rules governing retirement savings. Under current law, a spouse working in the home is discriminated against by being limited to an annual tax deduction of only $250 for savings set aside for retirement. A spouse working outside the home may set aside up to $2,000 tax free. We are proposing that this discrimination be dropped by allowing a spouse working at home the same $2,000 retirement savings deduction to which spouses earning income outside the home are eligible.

The tax treatment of Social Security benefits will remain unchanged. Military allowances and veterans' disability payments will remain wholly tax free, as will parsonage allowances and the insurance activities of fraternal benefit societies.

Taken as a whole, the President's proposal to reform the tax code will remove much of the complexity from the tax calculations of the typical family. Because some deductions and exclusions are swapped for lower tax rates, far fewer families will need to itemize their deductions in order to obtain the lowest tax for which they are liable. Those who elect to report itemized deductions will drop from one-third of all current-law tax returns to one-fourth of all tax returns filed under the President's plan. Of the remaining three-fourths, many could have the IRS compute their tax bills for them if they so desired. This return-free system, which would be entirely optional, would be made possible by a combination of (1) the improved use of information reported by employers and payers of other forms of income and (2) the simpler rules for determining tax liability once income is known. When fully implemented, the return-free system could save taxpayers an estimated 71 million hours in actual return preparation time and $1.6 billion in fees now paid for professional tax return preparation.

Taxpayer Examples

The typical family, consisting of a mother and father with two dependent children and earning the median income of $33,600 in 1986, will receive a tax cut of $394, or more than 11 percent of their $3,454 tax bill under current law. This tax cut results from lower tax rates and the more generous personal exemption being more than enough to make up for the loss of state and local tax deductions totaling $2,200 (the average for such families) and an estimated $300 increase in income subject to tax due to including the first $25 per month of a family's employer-paid health insurance premiums.

A young person just starting out and supporting himself or herself on earnings of only $10,000 will discover our program provides a tax reduction of $98, again a cut of more than 11 percent from the current law liability of $863. In this example, the marginal tax rate will remain at its current law value of 15 percent. However, what is important to this young individual, full of hope for future success, is that under the President's plan, the 15 percent rate will continue to apply up until taxable income reaches $18,000. In contrast, under current law, taxable income of $18,000 would be taxed at 8 different marginal rates, ranging from 11 percent up to, and including, 23 percent.

An elderly couple living out their retirement years on Social Security benefits of $9,000 and a pension of $6,000, supplemented by interest income of $3,000, and dividends of $1,000, will not be required to pay any federal income tax under our program. Since their current law tax of $199 will be eliminated, their tax change represents a cut of 100 percent.

Not everyone will have a tax reduction under our proposals, but 79.3 percent of all families and individuals will have their taxes cut -- or they will experience no change because they remain nontaxable. The other 20.7 percent who will see their tax bills rise by an average of 17 percent do not, however, look much like the people in the three situations just described. Most are not sympathetic cases. In every instance, those whose taxes will increase under our proposals are enjoying -- to a greater or lesser degree -- special current law tax benefits or concessions that are not used by the majority.

The two charts appended to my testimony summarize the impact of the President's proposals on individual taxpayers. Chart 1 shows that 79.3 percent of all families will either receive a tax reduction or experience no change in tax, while 20.7 percent will have their taxes increased. The average change in individual income taxes for all families will be a reduction of 7.0 percent. This overall change, together with the breakdown by income level, appears on Chart 2. All families with less than $20,000 of income will receive, on average, tax reductions of 18.3 percent. Those with income in the $20,000 to $50,000 range will experience a 7.2 percent average reduction. Those with family income greater than $50,000 will have their taxes cut by 5.8 percent.

Taxes on Business and Capital Income

In order to enhance growth, the President proposes that the top tax rate for corporations be reduced to 33 percent, just below the top individual tax rate of 35 percent. Broad incentives for capital formation will be retained, but business tax preferences that favor only certain sectors of the economy or that favor only certain forms of investment should, absent compelling national interest to the contrary, generally be eliminated.

Incentives for Economic Growth and Neutrality

The President's plan for remodeling the tax system places great emphasis on stimulating growth through capital formation. Investment incentives are maintained through a system of depreciation allowances that is accelerated relative to economic depreciation. Incentives for innovation and risk-taking will be strengthened by targeting more accurately the credit for research and experimentation and by providing a 50 percent exclusion for individual long-term capital gains. Thus, under the President's proposals, the top rate of tax paid on capital gains by individuals would be reduced from 20 percent to 17.5 percent.

Like growth, economic neutrality is fundamental to the President's plan. This means that all investment should be encouraged equally; the tax system should not be used to implement an implicit industrial policy by encouraging investments in some sectors and in some depreciable asset categories more than others. Under the President's plan, tax-induced distortions among different types of investment will be reduced in several ways:

- The investment tax credit, which is available for investment in equipment, but generally not for investment in structures, would be repealed;
- All other business credits, except for the foreign tax credit that is required to prevent double taxation of foreign source income and the credit for research and experimentation, would be eliminated;
- Businesses would be allowed to use LIFO inventory accounting without the obligation of conforming their tax and financial accounting reports or to use FIFO inventory accounting indexed to reflect changes in the value of cost of goods sold from inventories;
- Corporations would be permitted to deduct dividends paid to their shareholders, limited for now to 10 percent of dividends paid; and
- The depreciation system would be revised to account explicitly for inflation and to reflect economic depreciation more accurately, while preserving important investment incentives.

The incentives for all investment that will be provided through the system of depreciation allowances the President is proposing deserve special attention. The current law accelerated cost recovery system (ACRS), in combination with the investment tax credit (ITC), discriminates in favor of investment in machinery and equipment -- especially long-lived heavy machinery and ships -- and against investment in industrial structures and in assets with short economic lives, such as high tech equipment that can become obsolete more rapidly than anticipated.

This discrimination is especially severe in periods of low inflation. The ACRS allowances, which were introduced, in part, as offsets for inflation, can overcompensate for inflation and generate negative effective tax rates on income from investments, especially when combined with the ITC. While incentives for investment are desirable, we should not provide tax treatment that is more favorable than tax exemption.

In place of the ITC and the ACRS system, the President is proposing an improved capital cost recovery system (CCRS). CCRS will distinguish among assets by assigning them to 6 separate classes, each of which carries a different depreciation rate and a different recovery period. For example, short-lived equipment, class 1 property, is assigned a 55 percent depreciation rate and 4-year recovery period. At the other extreme, structures in class 6 are assigned a 4 percent rate of depreciation and a 28-year recovery period. The CCRS system will explicitly account for inflation by allowing deductions for the real, inflation adjusted, cost of an asset, rather than for historical costs only, as under current law. As a result, the effective tax rates I just mentioned will no longer depend on the rate of inflation; an important departure from current law.

All depreciation rates are deliberately set higher than would be required for economic depreciation, but in such a way that a corporation subject to the 33 percent corporate tax would pay a uniform 18 percent effective tax rate on income from any investment in equipment. (This rate will be 17 percent, once account is taken of the deduction for dividends paid.) The 25 percent effective tax rate on income from investment in structures, although lower than the current law rate, is somewhat higher than the rate on investment in equipment, reflecting the national priority for investment in equipment. In addition, debt financing is more common for structures than it is for equipment. Since leverage effectively reduces the effective rate of tax on income from investments, the disparity in effective rates is reduced when financing practices are considered.

The effective tax rate on income from inventories will be the statutory marginal rate, 33 percent in the case of large corporations. Though somewhat above the effective tax rates yielded by investments in equipment and structures, this effective rate will be well below the effective rate produced under current law.

Under current law, corporate income that is distributed to shareholders bears two taxes, first at the corporate level and then again at the shareholder level. This double taxation of dividends causes under-investment in the corporate sector and in the economy as a whole; it encourages the use of debt finance even when equity finance may be more appropriate, and it impedes the efficient allocation of the nation's capital. Though only a modest step toward eliminating these distortions, the deduction for 10 percent of dividends paid would be an important start in reversing this misguided tax policy.

Denial of Unforeseen Rate Reduction Benefits with Respect to Certain Pre-1986 Investments

Accelerated depreciation allows businesses to defer tax, to the extent of the acceleration. That deferral is the basic advantage provided by accelerated depreciation, and is entirely proper as a stimulus to investment. But when tax rates are reduced, as proposed by the President, the combination of deferred tax liabilities and rate reductions results in benefits that taxpayers did not foresee at the time they undertook investment, and which were not necessary to justify the investment. For large corporations, this unintended benefit would be 13 percent of the excess of tax depreciation over economic depreciation -- the difference between the current top corporate rate of 46 percent and the proposed 33 percent -- when the corporate rate is reduced.

The President is proposing that taxpayers whose total depreciation deductions taken between January 1, 1980, and December 31, 1985, are less than $400,000 would not be subject to any rate-reduction recapture. However, those who receive this unintended benefit and whose deductions exceed the $400,000 threshold could be affected by a rate recapture rule on deductions for assets placed in service before January 1, 1986. This rule would not affect the cost of new capital. Moreover, the tax after applying the recapture rule should be roughly equal to the tax anticipated at the time the depreciable assets were acquired.

Energy Industry

Current law treatment of the oil and gas industry causes more resources to be allocated to energy development than under a totally neutral system. This treatment has been maintained because of a concern for national security that recognizes the importance of readily accessible domestic sources of oil and gas and decreased reliance on unreliable foreign sources. Accordingly, the President's plan for tax reform carefully balances the principle of economic neutrality and fairness against the need to retain incentives for exploration and development of energy resources.

Percentage depletion is not an efficient subsidy for the provision of energy resources. The President proposes to phase out the allowance for percentage depletion over a 5-year period. However, for stripper wells (producing fewer than 10 barrels of oil per day), which account for some 15 percent of domestic production and which would more likely be irreversibly plugged and abandoned without preferential tax treatment, percentage depletion would be continued. It would not be retained, however, for royalty owners.

In order to assure the exploration for and discovery and development of domestic oil and gas resources, the current treatment of intangible drilling costs for successful wells, as well as dry holes, will be retained. At the same time, however, the preference associated with immediate expensing will be included in a meaningful way in a tightened minimum tax, in order to assure that all taxpayers pay a fair share.

Minimum Taxes

Nothing upsets the average American taxpayer's sense of fair play more than hearing about high-income individuals or successful businesses being able to avoid income tax altogether by pyramiding special tax concessions, one on top of the other, to an extent never intended by Congress. Because any practical program for tax reform will not close every loophole and dismantle every shelter that may permit this kind of unpopular abuse, the President is wisely recommending strengthened minimum taxes for both corporations and individuals.

The minimum tax for both corporations and individuals would be a 20 percent alternative tax on an income base that would be expanded to include preferences retained for oil and gas exploration and development. Eight percent of intangible drilling costs, without the income offset contained in current law, would be included in the minimum tax base. This amount equals the estimated value of the deferral benefit produced from current expensing of intangible drilling costs. Elimination of the income offset, which frequently reduces the intangible drilling costs tax preference to zero under current law, will assure that the preference for intangible drilling costs is properly reflected in the minimum tax income base. In addition, the expanded minimum tax income base will include the untaxed appreciation component of property donated to charity and preferences resulting from the combination of net interest expense and the excess of personal property depreciation deductions allowed under CCRS over those that would be allowed under a pure system of economic depreciation.

Economic Impact

Analysis by the Treasury Department indicates that these proposals should have a favorable impact on capital formation and economic growth. According to our estimates, the overall effective tax rate on equity-financed capital will be almost 20 percent lower than under current law. Although it is true that repeal of the investment tax credit will raise the effective tax rate on some equipment, this is more than offset by the substantially lower effective tax rate on industrial and commercial structures and inventories. Thus, under the President's plan, there should be a shift in the composition of investment toward more industrial and commercial structures and inventories, producing a correspondingly longer average life of capital. A longer average life of capital will improve economic efficiency and encourage greater total investment since the same amount of gross investment will yield more net investment and capital formation.

Conclusion

I would like to reiterate my opening remarks. The proposals I have discussed today are the President's. They reflect his decisions and he stands squarely behind them.

The process by which the Administration arrived at this particular set of proposals marks the beginning of a grass roots campaign for tax reform. Over the past few months since the Treasury Department's proposals for fundamental tax reform were made public, we have held hundreds of meetings with different groups of individuals, academicians, and business leaders in order to benefit from their thoughts on tax reform. These meetings provided constructive criticisms of the original Treasury proposals and thoughtful ideas concerning alternatives.

There is a growing awareness of the importance of tax reform to the long-run strength of the economy, even among groups that are particularly favored by current law, and, consequently, would be disfavored by a switch to a more neutral tax structure. Although they realize there may be short-term economic dislocations to which they must adjust, the overall benefits of fundamental tax reform are too great for them to ignore.

The President's final proposals also reflect meetings with leaders of Congress, authors of Congressional tax reform legislation, and members of the tax-writing committees of Congress. I have said all along that we will not be able to succeed unless we mount a bipartisan effort and obtain firm commitments from members on both sides of the aisle.

Finally, it is the American people who want, and who deserve, a new tax structure. They want simplicity and fairness -- and they want it now. They deserve a system of taxation that encourages invention, innovation, and savings for the future -- and they deserve it now.

We cannot risk the breakdown in our democratic institutions that the President warned could occur when a government begins taxing above a certain level of the people's earnings. Our form of government cannot survive if people cannot place their trust in it.

With bipartisan dedication and support from the American public, together we can implement the kind of tax structure Americans want and deserve -- a system that promotes growth, that is simple, and that, most importantly, is perceived to be fair and is fair.

Mr. Chairman, we appreciate your firm commitment to significant tax reform. The President and those of us charged with providing him with advice on tax policy are also committed. Moreover, we share with you a determination to seize this rare moment when Republicans and Democrats may come together to create a tax system that is simpler for many, fairer and more growth-oriented for all.

We have enjoyed working with you and members of the Committee as we have developed the President's proposals. We look forward to working with you as you begin the task of translating these proposals into law.

oOo

Percent of Returns Not Itemizing State and Local Taxes and Percentage Tax Reduction for Median Income Families in High-Tax States 1/

State	Percent of Returns Not Itemizing Taxes Paid 2/	Percentage Tax Reduction for Median Income Families Under the President's Proposal 2/	
		Non-Itemizers	Itemizers
California	62.8%	-26.5%	-10.2%
Colorado	55.3	-26.8	-14.0
Connecticut	66.2	-24.5	-13.7
Delaware	58.8	-26.3	-11.1
District of Columbia	65.8	-23.1	-9.4
Hawaii	65.6	-26.2	-12.0
Maryland	55.3	-26.2	-11.8
Massachusetts	65.9	-27.6	-12.6
Michigan	59.1	-24.1	-6.0
Minnesota	58.4	-25.5	-8.6
New Jersey	64.9	-25.4	-12.1
New York	56.1	-25.2	-4.2
Oregon	60.3	-21.5	-7.2
Rhode Island	68.2	-23.7	-12.8
Virginia	65.9	-26.1	-11.1
Wisconsin	63.2	-23.5	-6.4
U.S. Total	66.6%	-23.8%	-9.2%

Office of the Secretary of the Treasury
Office of Tax Analysis

June 11, 1985

1/ High-tax states are defined as states with per capita tax savings from deductions of state and local taxes greater than the U.S. average.
2/ 1982 law, 1982 levels.
3/ Hypothetical one-earner couple with two dependents earning the estimated median income in their state in 1986.

Note: The favorable pattern shown here is similar for non-itemizers in other states and even more favorable for itemizing taxpayers living in the low-tax states.

Chart 1

FAMILIES WITH TAX CHANGE
Under the President's Proposal

(As a Percent of All Families)

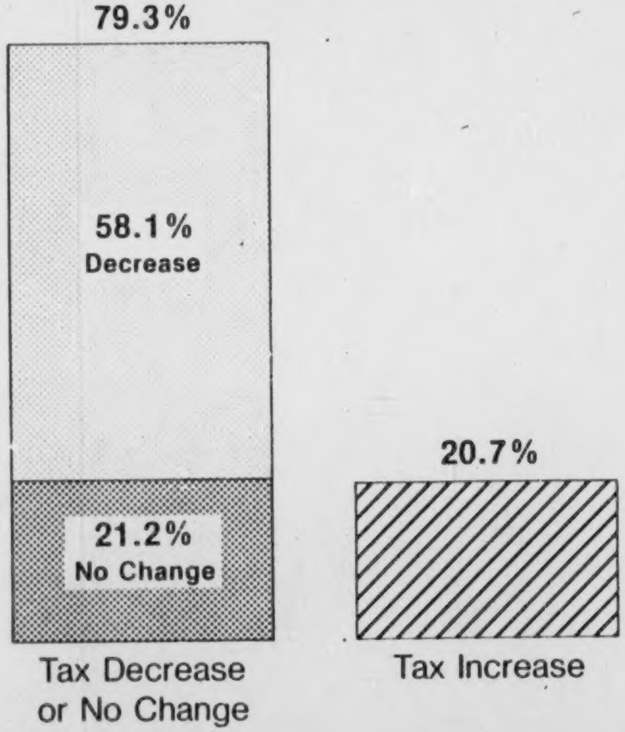
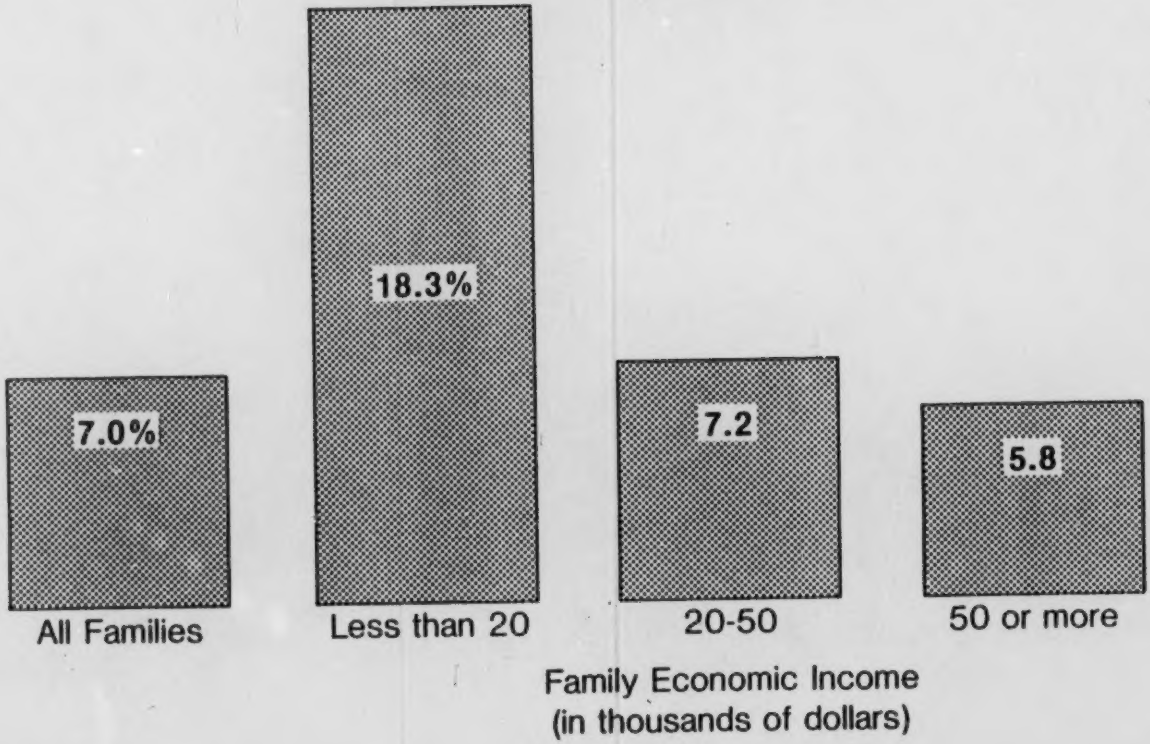


Chart 2

PERCENTAGE TAX REDUCTION
Under the President's Proposal



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United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510

June 10, 1985

The Honorable James A. Baker III
Secretary of the Treasury
Department of the Treasury
Washington, D.C. 20220

Dear Jim:

The ambitious tax reform proposal presented by President Reagan to Congress and the American people on May 28 professes the very laudable goals of simplicity, fairness, and growth.

I support and applaud the President's effort to broaden the tax base, reduce tax burdens for working Americans, and curb the tax advantages granted to special interests. However, I am very disturbed by the provision that would eliminate the deductibility of state and local taxes. I believe that enactment of this provision would be extremely harmful to the fiscal health of our intergovernmental system.

Jim, in a letter I sent to you in January, I cautioned that in our haste to reform the tax code and solve the budget dilemma, we sometimes overlook the legitimate needs and problems of state and local governments. I described how important the deduction of state and local taxes is in preserving the integrity of state and local governments as viable partners in our federal system. In the face of tax revolts and reduced federal aid, this deduction helps to protect the ability of state and local governments to raise revenues and deliver needed services. Additionally, it serves to lessen harmful tax competition among states by helping cushion the effect of fiscal differences among them.

In that letter and in our meeting prior to your confirmation, I also urged you to consider the needs of the intergovernmental system and to work closely with state and local officials in seeking ways to make the system work more effectively.

State and local tax deductibility is now at the center of the debate surrounding tax reform, and discord is mounting. If the line between those who favor deductibility and those who don't is drawn too hard, deductibility of state and local taxes threatens to be the major stumbling block to achieving tax reform this year. I have offered a compromise which I believe strikes a reasonable balance between the concerns of state and local governments and the goals of tax reform. I am certain this compromise can be the vehicle that will enable us to move ahead.

Before I discuss my plan further, I'd like to express some concerns I have regarding the justifications for the elimination of state and local tax deduction that were presented in the President's tax plan. I'm afraid they just don't tell the whole story. Because the President's proposal rejects deductibility entirely and the rationale for this is so inadequate, I feel compelled to discuss the case for deductibility at length. In the interests of balanced and comprehensive tax reform, I am willing to concede that state and local governments contribute their fair share to broadening the tax base. But I am deeply dismayed that the President should place such a disproportionate burden on this one deduction, and state publicly that everything but this is open to negotiation.

The deduction of state and local taxes has been a significant feature of our tax code since 1913. It should not be taken lightly. To call this deduction "one of the most serious omissions from the federal income tax base" totally ignores the basic precepts of federalism upon which our system of government is founded and which the President has worked so hard to strengthen in the past. State and local governments are not just another interest group protecting a "fat-cat loophole." I think you will agree that there are fundamental differences between tax deductions which support education, health care for the poor, and public transportation and those that support three-martini lunches, country club memberships, and season tickets to professional sports.

Our national, state, and local governments are joined in a single system of government, sharing responsibilities and resources. There are, however, tensions associated with our federalist form of government. We both know that taxpayers have their limits when it comes to paying taxes; the more the national government taxes them, the less state and local governments are politically able to raise revenue. Resistance to state and local taxes is even greater when taxpayers feel they are being taxed twice on the same income. Deductibility prevents the more powerful national government from capturing all of the tax base and helps preserve a vital portion of that base for state and local governments.

The deduction for state and local taxes does a lot more than let people pay fewer taxes, however. It makes it easier for state and local governments to raise revenues to meet the needs of their citizens. This deduction becomes even more critical when you consider other pressures working on the intergovernmental system. I have stood firmly with the President on making tough decisions to eliminate and cut back federal programs to reduce the deficit. But past declines in the growth of federal grants, as well as further cutbacks in the current budget will make it almost impossible for state and local governments to maintain adequate service levels, let alone take on added responsibilities under New Federalism. Deductibility is needed to help fill the gap. Relying on phoney state and local surpluses won't do the trick. As I've said before, Treasury's forecast of an $80 billion state and local budget surplus by 1989 is just not realistic. It certainly provides no justification for eliminating the deduction.

A major argument advanced in the tax plan is that state and local taxes are voluntary costs incurred by residents for the services they receive. By making these costs deductible, individuals in low-tax states subsidize the individuals in high-tax states who have a preference for more government services.

This reasoning is not entirely correct. We both know there are factors other than preference for big government which cause disparities in tax rates between states. And I firmly believe that encouraging adequate service provision and healthy revenue systems at the state and local levels is the best way to avoid further pressures for doing more and more from Washington.

Many state and local services provide general benefits to society rather than direct benefits to individual taxpayers. In fact, traditional economic theory states that without government provision, some of these services, such as income support and pollution control, would not be produced or would be produced at an insufficient level.

In addition, states such as New York and California have large urban areas with added needs and a larger than average percentage of the nation's poor. These states, and central cities across the country, must impose a heavier tax burden on the non-poor so that ordinary public services--education, police, income support--are provided at adequate levels. Without deductibility, the high-income taxpayer who does not receive a direct benefit from these services faces an incentive to move to lower tax jurisdictions, leaving behind a depleted tax base which cannot support the low-income population.

Some states have lower individual tax rates because they are able to generate revenue from other sources such as natural resources, manufacturing, or financial transactions. I'm certain that Wyoming's high capacity to levy severance taxes on oil, gas, and coal is a major reason why that state does not levy personal income taxes.

Some states have more residents to tax, or residents with more income to tax. Some states make a greater tax effort and get less for it. For example, Mississippi, whose tax capacity is relatively low, must tax its residents 2 1/2 times more than Alaska to raise the same per capita revenues.

Deductibility does not totally eliminate the disparities among states, but it does provide a cushion for states and localities losing population and business to wealthy areas with lower tax rates. And when the risk of harmful tax competition is reduced, taxing policy is more apt to reflect true needs and public preferences for services. That is one reason why recent polls show that the majority of taxpayers favor keeping the deduction.

The President's tax proposal also attacks the deduction because it disproportionately benefits high-income taxpayers. Although the benefit to high-income taxpayers who itemize is significant, the deduction is also vital to the middle class. In fact, one half of all households with incomes between $20,000 and $25,000 and two thirds of all households with incomes between $25,000 and $30,000 utilize the deduction. Seventy-four percent of all households taking the deduction have incomes below $40,000 a year. Thus, the middle class also benefits directly from the deduction. And low-income individuals receive benefits from the higher service levels that itemizers are willing to support.

Because the actual dollar amount of the deduction is proportionally greater as one moves up the income scale, some have said that the deduction reduces the progressivity of the federal income tax. Yet so does the President's own reform plan. And deductibility has provided an incentive for state and local governments to rely on less regressive taxes and to increase their reliance on progressive income taxes. On balance, I believe the system of national, state and local taxes is more progressive because of the state and local tax deduction. Eliminating deductibility may lead to a reduction in the progressivity of the state tax structure in the future.

For every $1 the federal government loses because of the deduction, state and local spending increases by less than 50 cents. The tax plan calls this an ineffective subsidy for state and local government spending. I call it a price we pay for a healthy intergovernmental fiscal system. The framers of the Constitution didn't invent federalism, with all its checks and balances, because it would be the most "efficient" system. They created a federal system to be responsive to local preferences and to avoid excessive concentrations of power in Washington. Besides, it is well known that federal grants are often "fungible." State and local governments often use federal grant monies as replacements for their own spending, enabling lower tax rates. In contrast, because deductibility operates like an open-ended matching grant, it may provide a greater stimulus to state and local spending than general revenue sharing or block grants.

Jim, you can see that I feel strongly about the importance of state and local tax deductibility to our system of fiscal federalism. While I agree that state and local governments should make some contribution to comprehensive tax reform, outright elimination is not the answer.

In searching for alternatives to outright repeal, some have suggested selective repeal of deductibility for certain taxes. For example, the Bradley-Gephardt flat tax plan repeals the deduction of state and local sales, and personal property taxes. The Kemp-Kasten proposal would eliminate the deduction for state and local income, sales, and personal property taxes. These approaches are just as dangerous to the intergovernmental fiscal system as total elimination. They would have the federal government tell state and local governments what kind of taxes they should utilize, ignoring past political choices about what taxes are most appropriate for that jurisdiction.

Selectively repealing the deductibility of sales or any of the other three major state and local taxes would be unwarranted federal interference into state and local policy making.

As responsible policymakers representing all levels of government, we face a dilemma. We must reconcile a genuine need to broaden the federal revenue base with the need to preserve the intergovernmental fiscal benefits of this deduction. What is more, given the growing--and justified--opposition to eliminating deductibility, we face losing this historic opportunity for tax reform altogether if changes are not made. With the proper balance, I believe it can be done.

Earlier this year, I offered a compromise proposal which gives back a portion of the deduction without jeopardizing the role the deduction plays in fiscal federalism. I believe this proposal will put us on the right track to tax reform. The National Governors' Association has already given its endorsement to the concept.

Under my proposal, each itemizing taxpayer could pool his or her state and local taxes and deduct that amount exceeding one percent of adjusted gross income.

I didn't choose this threshold randomly. In 1980, the average taxpayer taking the state and local tax deduction claimed an amount equal to about six percent of adjusted gross income. The average deduction ranged from three percent AGI in Wyoming to 12.6 percent AGI in New York. With the one percent floor, two thirds of the average itemizer's tax payments in the state with the lowest overall tax burden, Wyoming, remains deductible.

If my proposal had been included in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), it would have raised $21 billion between fiscal years 1985-1988, according to estimates of the Joint Tax Committee. By comparison, if we had selectively repealed the sales tax deduction, we would have raised $24 billion over the same period.

This plan would also add progressivity to the state and local tax deduction. For example, a person in the 14 percent bracket might face an increase of only a few dollars, while a person in the highest marginal tax bracket would pay several hundred dollars more.

Jim, I hope you feel as I do that this proposal is a viable alternative.

Do not insist that state and local governments bear all the costs of tax reform. If you do, it will leave them no choice except to match the Administration's intransigence. This, in turn, could well be the undoing of tax reform in this Congress. America deserves tax reform, not tax stalemate.

Sincerely,

Dave Durenberger
United States Senator

DD:mwd

Secretary **Baker**. I last appeared before this committee on January 23 in connection with my nomination by the President to be Secretary of the Treasury. Since then, I have spent a great deal of time consulting with your chairman and with members from both sides of the table as we developed the President's proposal. Before going any further, I would like to thank each of you for sharing your insights with us. Although we may not have embraced every one of your ideas, we did learn and benefit a great deal from our discussions with you.

On May 28, the President announced his proposals for sweeping changes in the Federal income tax structure. In his address to the Nation, he emphasized the importance of this to all of us when he said: "No other issue goes so directly to the heart of our economic life; no other issue will have more lasting impact on the well-being of your families and your future."

I want to stress that these proposals, Mr. Chairman, are the President's. He reviewed our recommendations. He considered the options. And he made all of the final decisions. The President stands squarely behind these proposals. As you know, since they were announced, the President has been using his very commanding power of persuasion to communicate the benefits of these proposals to the American people. And to date, we have been greatly encouraged by the responses. In his State of the Union Address earlier this year, the President enumerated the following tax reform goals:

Tax reform should not be a tax increase in disguise;

Personal tax rates should be reduced by removing many preferences, with a top rate no higher than 35 percent;

Corporate tax rates should be reduced while maintaining incentives for capital formation;

Individuals with incomes at or near the poverty level should be exempt from income tax; and

The home mortgage interest deduction should not be jeopardized.

Today, I am prepared to discuss with you the administration's specific proposals for remodeling our tax structure to achieve those goals.

The current body of Federal tax law commonly identified as the 1954 Code is now some 30 years old. Over the span of three decades, the law has been tinkered with so often and weighed down by so many amendments that its original drafters may have difficulty recognizing it. Although we are not recommending outright repeal of the current Code, we are recommending that instead of more tinkering, we should make some very basic, fundamental changes to remodel the Code. These changes will eliminate the need for some complicated rules. They will help restore free-market principles to economic decisionmaking. And they will streamline tax calculations for many individuals.

The average taxpayer has become convinced that others benefit from this growing complexity, and that he or she does not. He or she understands very well that as long as the tax law permits others to shelter income and thereby avoid paying a fair share of tax, then he or she must make up the difference by paying a greater share. There is also a pervasive feeling that complexity breeds unfairness; that the tax system must be unfair because it is so complex.

Most taxpayers feel that they have to pay more than their fair share of tax because complexities in the system give unwarranted benefits to others. According to a recent survey commissioned by the Internal Revenue Service, fully 80 percent of all taxpayers believe the present tax system benefits the rich and is unfair to the ordinary working man or woman, and a majority of the respondents felt that the system is too complicated.

The President has responded to the demands of the American taxpayers with a comprehensive set of tax reform proposals designed for fairness, growth, and simplicity. These proposals do not represent yet another attempt to tinker with current law. Instead, they are intended to remodel current law.

Mr. Chairman, this morning I would like to discuss the most important aspects of our plan. A complete and detailed description of each proposal can be found in the report which the President has transmitted to the Congress. The President proposes to reduce individual income tax rates by replacing the current schedule of 14 marginal tax rates, 15 for single returns, ranging from 11 percent to 50 percent, with a simple three-bracket system having rates of 15, 25, and 35 percent.

The President calls this proposal to remodel the tax laws a "profamily proposal," and it is. Families will benefit directly from reduced marginal tax rates. Just as important, they will take comfort in the fact that the highest rate they will ever face is just 35 percent. It is an integral part of the American dream to look forward to the day when an investment in human capital—the college education—or an investment in physical capital—the new business venture—may some day yield a big payoff. It is satisfying to know that when that day comes, the Government will never again be in a position to take more than 35 cents of every dollar earned.

By throwing out many special deductions, exemptions and credits that benefit relatively few individuals, we've been able to abandon high tax rates for the benefit of all taxpayers. We are not, however, abandoning features of current law that are justified, that make good sense, or that provide widespread family benefits. Instead, we are seeking to strengthen these provisions.

For example, we propose raising the value of the personal exemption to almost twice its current level, and we recommend expanding the income bracket to which a zero rate of tax applies. The per capita personal exemption would be raised in 1986 from $1,080 to $2,000, and the zero bracket amount would be raised from $3,670 to $4,000 for all married taxpayers filing joint returns, and from $2,480 to $3,600 for families headed by one parent.

Taken together, these proposals guarantee that families living in poverty and families whose incomes are near the poverty level will no longer be required to pay Federal income tax.

For families somewhat better off, this means that the amount of income that can be received tax free is substantially raised. For instance, under the President's plan a family of four will pay no tax on the first $12,000 of income received, whereas they could begin paying tax with less than $8,000 of income under current law. Indeed, if the $12,000 consists entirely of earnings, this family of four will actually receive an earned income credit refund of $200, even though no tax would have been paid.

We propose repealing the deductions for State and local taxes. Only one-third of all taxpayers itemize deductions, and this group includes most high-income families and very few low-income families. As a result, the cost of a family's State and local tax burden that is borne by the Federal Government increases as the family's marginal tax rate increases. Thus, the deduction can convert a State or local tax that is designed to be proportional into one that is regressive.

We propose retaining deductions for home mortgage interest on a principal residence, charitable contributions, medical expenses, and casualty losses. And we propose limiting deductions for still other expenses, Interest, other than mortgage interest on a principal residence, will be limited to investment income, plus $5,000. And miscellaneous expenses, such as other investment expenses, union dues, tax return preparation fees, certain educational expenses, and unreimbursed employee business expenses will be deductible only to the extent that together they exceed 1 percent of income floor.

For most families, the loss of these repealed or scaled-back deductions will be more than offset by reduced tax rates and increased levels of the personal exemption and the zero bracket amount.

Officials from States and localities that levy high rates of tax have been outspoken in their condemnation of our proposed elimination of deductions for State and local taxes. They argue that repeal of the deduction will be unfair to citizens of high tax States, that repeal will constitute a tax on a tax, that repeal will require massive cutbacks in public services supplied by State and local governments, and that taxpayers in some States will face huge tax increases.

Repeal appears unfair to those speaking on behalf of the high tax jurisdictions only because current law is so biased in their favor. In truth, repeal will restore fairness among States and localities and within jurisdictions between itemizers and nonitemizers.

The arguments advanced by the high tax States are not persuasive for several reasons. First, since two-thirds of all taxpayers do not itemize their deductions, the deduction is a subsidy for the few who do itemize. Second, since there are 35 States with relatively low tax rates, the deduction is a subsidy for those living in the few high tax States. Third, since those that do itemize are concentrated in the high-income brackets, the deduction is a subsidy directed at a relatively small number of high-income taxpayers. Fourth, because so many States base their income taxes on Federal tax concepts and definitions, base broadening at the Federal level will produce an opportunity for revenue gain for the conforming States. This should alleviate any concern that these States will be forced to cut back on services financed by State income taxes.

Last, even families living in high tax States—those States in which the per capita tax savings from deductibility exceeds the average for the country as a whole—will not suffer tax increases if their incomes are at the median for their State. The attached table shows that the median income family living in each of the 15 high tax States, plus the District of Columbia, and currently itemizing deductions will realize a tax cut under the President's proposal. Median income nonitemizers and itemizers living in the other 35 low tax States will have an even larger tax reduction.

A recognition that a spouse working at home performs valuable service to the family is long overdue in our tax rules governing retirement savings. Under current law, a spouse working in the home is discriminated against by being limited to annual tax deduction of only $250 for savings set aside for retirement. A spouse working outside the home may set aside up to $2,000 tax free. We are proposing that this discrimination be dropped by allowing a spouse working at home the same $2,000 retirement savings deduction.

The two charts appended to my testimony summarize the impact of the President's proposal on individual taxpayers. Chart I shows that 79.3 percent of all families will either receive a tax reduction or experience no change in tax, while 20.7 percent will have their taxes increased.

The average change in individual income taxes for all families will be a reduction of 7 percent. This overall change, together with the breakdown by income level, appears on chart II, the orange bars. All families with less than $20,000 of income will receive on average a tax reduction of 18.3 percent. Those with incomes in the $20,000 to $50,000 range will experience a 7.2-percent average reduction. And those with family incomes greater than $50,000 will have their taxes cut by 5.8 percent.

And, Senator Roth, if I may say so, it seems to me that that chart would indicate that our proposal is simply not unfair to the middle-income taxpayer.

In order to enhance growth, the President proposes that the top tax rate for corporations be reduced to 33 percent, just below the top individual tax rate of 35 percent. Broad incentives for capital formation will be retained, but business tax preferences that favor only certain sectors of the economy or that favor only certain forms of investment should, absent compelling national interest to the contrary, generally be eliminated.

Investment incentives are maintained through a system of depreciation allowances that is accelerated relative to economic depreciation. Incentives for innovation and risk-taking will be strengthened by targeting more accurately the credit for research and experimentation and providing a 50-percent exclusion for individual long-term capital gains. Thus, under the President's proposals, the top rate of tax paid on capital gains by individuals would be reduced from 20 percent to 17½ percent. Under the President's plan, tax-induced distortions among different types of investment will be reduced in a number of ways. The investment tax credit, which is available for investment in equipment, but generally not for investment in structures, would be repealed. All other business credits, except for the foreign tax credit that is required to prevent double taxation of foreign source income, and the credit for research and experimentation, would be eliminated.

Businesses would be allowed to use LIFO inventory accounting without the obligation of conforming their tax and financial accounting reports or to use FIFO inventory accounting indexed to reflect changes in the value of cost of goods sold from inventory.

Corporations would be permitted to deduct dividends paid to their shareholders, limited for now to 10 percent of dividends paid.

And the depreciation system would be revised to account explicitly for inflation and to reflect economic depreciation more accurately while preserving important investment incentives.

The incentives for all investment that will be provided through the system of depreciation allowances the President is proposing deserves special attention. The current law accelerated cost recovery system, in combination with the investment tax credit, discriminates in favor of investment in machinery and equipment, especially long-lived heavy machinery and ships, and against investment in industrial structures and in assets with short economic lives, such as high-tech equipment that can become obsolete more rapidly than anticipated.

This discrimination is especially severe in periods of low inflation. The ACRS allowances which were introduced in part as an offset for inflation can over-compensate for inflation and generate negative effective tax rates on income from investments, especially when combined with the ITC. While incentives for investment are desirable, we should not provide tax treatment that is more favorable than tax exemption.

In place of the ITC and the ACRS system, the President is proposing an improved capital cost recovery system. CCRS will distinguish among assets by assigning them to six separate classes, each of which carries a different depreciation rate and a different recovery period. The CCRS system will explicitly account for inflation by allowing deductions for the real inflation adjusted cost of an asset rather than for historical costs only, as under current law.

All depreciation rates are deliberately set higher than would be required for economic depreciation, but in such a way that a corporation subject to the 33-percent corporate tax would pay a uniform 18 percent effective tax rate on income from any investment in equipment.

Under current law, corporate income that is distributed to shareholders bears two taxes—first, at the corporate level and then again at the shareholder level. This double taxation of dividends causes under-investment in the corporate sector and in the economy as a whole. It encourages the use of debt finance even when equity finance may be more appropriate, and it impedes the efficient allocation of the Nation's capital. Though only a modest step toward eliminating these distortions, the deduction for 10 percent of dividends paid would be an important start in reversing this misguided tax policy.

Accelerated depreciation allows businesses to defer tax to the extent of the acceleration. That deferral is the basic advantage provided by accelerated depreciation and is entirely proper as a stimulus to investment. But when tax rates are reduced, as proposed by the President, the combination of deferred tax liabilities and rate reductions result in benefits that taxpayers did not foresee at the time they undertook investment, and which were not necessary to justify the investment. For large corporations, this unintended benefit would be 13 percent of the excess of tax depreciation over economic depreciation, the difference between the current top corporate rate of 46 percent and the proposed 33 percent rate, when the corporate rate is reduced.

The President is proposing that taxpayers whose total depreciation deductions taken between January 1, 1980, and December 31, 1985, are less than $400,000 would not be subject to any rate-reduction recapture. However, those who receive this unintended benefit and whose deductions exceed the $400,000 threshold could be affected by a rate recapture rule on deductions for assets placed in service before January 1, 1986.

Current law treatment of the oil and gas industry causes more resources to be allocated to energy development than under a totally neutral system. This treatment has been maintained because of a concern for national security that recognizes the importance of readily accessible domestic sources of oil and gas and decreased reliance on unreliable foreign sources. Accordingly, the President's plan for tax reform carefully balances the principle of economic neutrality and fairness against the need to retain incentives for exploration and development of energy resources.

Percentage depletion is not an efficient subsidy for the provision of energy resources. The President proposes to phase out the allowance for percentage depletion over a 5-year period. However, for stripper wells producing fewer than 10 barrels of oil per day, which account for some 15 percent of domestic production, and which would more likely be irreversibly plugged and abandoned without preferential tax treatment, percentage depletion would be retained.

In order to assure the exploration for and discovery and development of domestic oil and gas resources, the current treatment of intangible drilling costs for successful wells, as well as dry holes, will be retained. At the same time, however, the preference associated with immediate expensing is included in a meaningful way in a tightened minimum tax in order to assure that all taxpayers pay a fair share.

Nothing upsets the average American taxpayer's sense of fair play more than hearing about high-income individuals or successful businesses being able to avoid income tax altogether by pyramiding special tax concessions one on top of the other to an extent never intended by Congress. Because any practical program for tax reform will not close every loophole and dismantle every shelter that may permit this kind of unpopular abuse, the President has wisely recommended strengthened minimum taxes for both corporations and individuals.

Analysis by the Treasury Department indicates that these proposals should have a favorable impact on capital formation and economic growth. According to our estimates, the overall effective tax rate on equity-financed capital will be almost 20 percent lower than under current law. Although it is true that repeal of the investment tax credit will raise the effective tax rate on some equipment, this is more than offset by the substantially lower effective tax rate on industrial and commercial structures and inventory. Thus, under the President's plan, there should be a shift in the composition of investment toward more industrial and commercial structures and inventories, producing a correspondingly longer average life of capital. A longer average life of capital will improve economic efficiency and encourage greater total investment since the same amount of gross investment will yield more net investment and more capital formation.

Mr. Chairman, I would like to reiterate my opening remarks. The proposals I have discussed today are the President's proposals. They reflect his decisions and he stands squarely behind them. The process by which the administration arrived at this particular set of proposals marks the beginning of a grass roots campaign for tax reform. Over the past few months since the Treasury Department's proposals for fundamental tax reform were made public, we have held hundreds of meetings with different groups of individuals, academicians and business leaders in order to benefit from their thoughts on tax reform. These meetings provided constructive criticisms of the original Treasury proposal, and thoughtful ideas concerning alternatives.

There is a growing awareness of the importance of tax reform to the long-run strength of the economy, even among groups that are particularly favored by current law, and consequently, would be disfavored by a switch to a more neutral tax structure. Although they realize there may be short-term economic dislocations to which they must adjust, the overall benefits of fundamental tax reform are too great for them to ignore.

The President's final proposals also reflect meetings with leaders of Congress, with authors of congressional tax reform legislation, and with members of the tax writing committees of the Congress. I have said all along that we will not be able to succeed unless we mount a bipartisan effort and obtain firm commitments from members on both sides of the aisle.

Finally, it is the American people who want and the American people who deserve a new tax structure. They want simplicity and fairness, and they want it now. They deserve a system of taxation that encourages invention, innovation and savings for the future, and they deserve it now.

Mr. Chairman, we appreciate your firm commitment to significant tax reform. The President and those of us charged with providing him with advice on tax policy are likewise committed. Moreover, we share with you a determination to seize this rare moment when Republicans and Democrats may come together to create a tax system that is simpler for many, fairer and more growth oriented for all.

We have enjoyed working with you and members of the committee, Mr. Chairman, as we have developed the President's proposals. We look forward to working with you as you begin the task of translating these proposals into law.

Thank you very much.

The CHAIRMAN. Mr. Secretary, thank you.

In this committee we operate on a first-come, first-served rule for asking questions, and we limit ourselves to 5 minutes on the first round. I will just read out the order so the members will know when they come.

Senators Dole, Moynihan, Chafee, Bentsen, Symms, Baucus, Packwood, Wallop, Heinz, Long, Bradley, Roth, Durenberger, Armstrong, and Mitchell. I think that's it.

Senator Dole.

Senator DOLE. Thank you, Mr. Chairman.

I would ask three quick questions and then submit some others for the record, if that is satisfactory with the Secretary.

Secretary BAKER. Yes, sir.

Senator DOLE. When will we have to pass this bill to make this January 1, 1986, effective date possible?

Secretary BAKER. When would you have to pass it?

Senator DOLE. In other words, if we don't pass this bill in December, how can you make the provisions effective in January?

Secretary BAKER. We can't, sir.

Senator DOLE. So how much of a slip are we talking about? How long would it take to implement, if we didn't pass the bill until September?

Secretary BAKER. I thought you said if you didn't pass it until——

Senator DOLE. In December, say, of 1985.

Secretary BAKER. Late December?

Senator DOLE. Yes.

Secretary BAKER. Well, I'm really not sure I understand your question. You mean how long would it be before we could implement it as an administrative matter?

Senator DOLE. Right.

Secretary BAKER. Oh, I would say give us a month. Senator Dole. A month?

Secretary BAKER. Yes, sir.

Senator DOLE. And then another question——

Secretary BAKER. Senator, if the bill were signed into law by the President in December, we could implement a January 1 date. I mean it would take us about a month to get everything in place.

Senator DOLE. So if it passes this year——

Secretary BAKER. If it passes this year, we could have an effective date of January 1, 1986. Yes, sir.

Senator DOLE. I think it's important that we get into that. We are a long way from there, but if we get into deciding whether we are going to take it up this year, what does that do to the implementing date.

Secondly, I understand that for all practical purposes the bill is now revenue neutral, even though it loses a small amount over the 5-year period. Some would say $12 billion and some would say more. Now how long does that stay revenue neutral. Once it goes up to $30 billion over 5 years, is that still revenue neutral?

Secretary BAKER. No, sir. We would consider it revenue neutral only as long as it's within 1 percent of total receipts during the period. Total receipts during the period, I think, are estimated to be $4.7 trillion.

Senator DOLE. How much is that?

Secretary BAKER. Well, what's 1 percent of that.

Senator DOLE. $47 billion?

Secretary BAKER. $47 billion, over 5 years, that's correct.

Senator DOLE. Now what if there were a tax increase at $47 billion. Is that still revenue neutral?

Secretary BAKER. If it's plus or minus, we would consider it neutral—if it's within 1 percent.

Senator DOLE. That's the point.

Secretary **Baker**. If it's within 1 percent, we would consider it revenue neutral. Now that's revenue neutrality.

Senator **Dole**. I'm not advocating anything, but I'm just saying is it consistent. If it's on the plus side, is it also on the minus side?

Secretary **Baker**. Yes.

Senator **Dole**. And that's interesting.

Secretary **Baker**. According to our estimates, we are within 0.24 percent of total receipts. According to our estimates, Senator, we are at $11.5 billion over the 5 years; $1.2 billion up in the first year, we are $1.2 billion down in the last, and we move it around in between, but that's 0.24 percent of total revenue during that period.

Senator **Dole**. I think the revenue estimate is fairly fine-tuned now. I'm just suggesting that the proposal may not be precisely revenue neutral—it could be $50 billion either way and you are suggesting that's about right.

Secretary **Baker**. Over 5 years.

Senator **Dole**. Under the present law, single individuals don't reach the top tax bracket until they have about $88,000 of income. Under your proposals, singles will be taxed at the top rate when they have more than $42,000 worth of income. And even though there is a 15-percent rate reduction, I think there are some who are going to question—is this fair.

Secretary **Baker**. Well, I think it's fair if you look at the——

Senator **Dole**. And there are a lot of single people out there.

Secretary **Baker**. Yes, sir; I do think it's fair if you look at the amount of rate reduction. They are going to get a full 15-percent reduction in the rate.

Senator **Dole**. That's not going to make up for what they are going to lose.

Secretary **Baker**. It will make up a substantial portion of it, Senator.

Senator **Dole**. I'm not sure how many singles there are, but I think it's a matter that——

Secretary **Baker**. And they will never be subjected to a higher rate.

Senator **Dole**. Yes.

Is there any rationale other than revenue impact for having an earlier effective date for certain revenue-raising provisions, such as repeal of State and local taxes, than for lowering the tax rates? I mean is that just to bring you in balance?

Secretary **Baker**. It is revenue considerations, Senator. Yes, sir.

Senator **Dole**. It's not policy.

Secretary **Baker**. No, sir. It's revenue considerations, but we would take note of the fact that we are increasing the—doubling the personal exemption effective immediately. So we don't think the taxpayers will be adversely impacted. But the purpose for the rates becoming effective July 1 and the elimination of most deductions January 1 is revenue considerations.

Senator **Dole**. How much money do we pick up in repealing the so-called marriage penalty provisions? If it's made insignificant by lower rates, why is the revenue gain so great?

Secretary **Baker**. Well, I think we pick up in the neighborhood of $9 billion, but the reason we pick up so much is because it's our view that the marriage penalty deduction today is not sufficiently targeted in that it benefits some couples who really don't suffer a marriage penalty. And we look at what we are doing with the personal exemptions, and the increase in the ZBA, which basically dwarfs any problems presented by the marriage penalty, and we are also eliminating 11 of 14 rates, so there is much less likelihood that a two-earner family will be thrown into a higher bracket.

Senator DOLE. Thank you.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Secretary, we all want to thank you for a superb opening statement, and take the liberty of acknowledging Mr. Pearlman as well. We welcome him.

You said that your target for revenue neutrality is plus or minus 1 percent over the 5-year run. In other words $50 billion is the range of normal error that you would accept. Now the Wall Street Journal reported yesterday that on Friday Mr. Stockman gave a number of Senators a re-estimate of revenues based upon the blue chip forecast theories. The estimates showed a deficit in 1988 of $175 billion as opposed to the $105 billion forecast in the Senate budget resolution. Presumably, the 2 earlier years are higher also.

When we look at these numbers and run them, they come out to a total drop over 3 years of $169 billion and perhaps with interest payments, around $250 billion. Some Senators have this report from Mr. Stockman, which is OMB's estimate. Could we ask if you would make the memorandum, or whatever it is, available to the full committee?

Secretary BAKER. It's my understanding, Senator, that it is nothing more than a blue chip forecast. And I thought that Mr. Stockman made it public yesterday, and I see no reason why it shouldn't be available to this committee. I do think that he tended to disagree with the conclusions reached, although he did cite the report.

Senator MOYNIHAN. It is clear that the revenue estimates are based on a projection of 4 percent real growth for 4 years and about the same for 5. That is something which we, historically, have never achieved in peacetime.

Secretary BAKER. That's correct, sir.

Senator MOYNIHAN. On Sunday, the Washington Post had what seemed to us a very useful proposal—we deal with this all the time in this committee—which is to say why doesn't the Treasury take the range of forecast that the actuaries and trustees for the Social Security fund use to forecast their revenue and do it the same for the tax proposal. Specifically there is an optimistic, there is a moderate, and there is a pessimistic. And then in the moderate there are two A, two B, as you well know.

We use the moderately pessimistic two B forecast. Do you think you could give this committee a forecast of revenues using these alternatives?

Secretary BAKER. I'm sure we could make those runs, Senator, but it does seem to me that we really ought to use the official administration forecast in terms of what we ourselves project as the result of submitting a proposal as comprehensive as this.

But if your question is could we run those, I think we could without a great deal of difficulty.

Senator **Moynihan**. We certainly would appreciate it. I say, with great respect, sir, that 4 years ago we had a revenue neutral tax proposal before us and we ended up with a $200 billion deficit for as far as the eye can see.

One last question on revenues. Dynamic models create real problems. It makes you assert that you know things that are mostly not knowable, requiring somewhat arbitrary judgments and so forth. For example, in your estimates in regards to the repeal of the deductibility of State and local taxes, if I am not mistaken, your estimate simply calculates the cost to the Treasury of this present arrangement and then declares that amount to be a revenue gain to the Treasury if deductibility is repealed. But this ignores the possibility that people will "vote with their feet." Surely there is the possibility of making some estimates of what would be the migration pattern from high tax jurisdictions to lower tax jurisdictions. Such migration inevitably would lower the revenues that you estimate you hope to gain.

Secretary **Baker**. It would lower the Federal revenues?

Senator **Moynihan**. You estimate that you will receive increased revenues equivalent to the amount of the deductions currently claimed. But you don't estimate anybody will change their residence in order to avoid this.

Secretary **Baker**. I'm not sure that I would agree, Senator Moynihan, that it would reduce the result at the Federal level. And I'm certainly not sure that we could make any reasonable estimates. It would be anything more than star-gazing with respect to what the impact would be in terms of people who might leave one State and go to another.

Senator **Moynihan**. But you admit to the possibility.

Secretary **Baker**. Do I admit there is a possibility some people might leave one State and go to another? Yes, sir, they do that today.

Senator **Moynihan**. And to the degree that they do it tomorrow under these arrangements, Treasury revenue projections would fall short again.

Secretary **Baker**. Well, I can't speculate on that. But people move from one tax jurisdiction to another for tax purposes today. I didn't mean that to be a smart-alecky answer.

Senator **Moynihan**. No, no. Thank you. Mr. Secretary, we can pursue this later. My time is up.

The **Chairman**. Oh, yes. We will have numerous rounds of questions.

Senator Chafee and then Senator Bentsen.

Senator **Chafee**. Mr. Secretary, under your proposal you take the lid off all the restrictions on fringe benefits, even removing some of the restrictions that we had, For example, on educational benefits. Yet you tax the first $300 of the health insurance benefits so that—two people side by side, one getting the minimum of Blue Cross coverage just for himself and not even covering his family, the other having unlimited coverage, dental, and everything for his family are taxed the same. How can you do that having an overriding interest of fairness we are trying to achieve here? What's the rationale?

Secretary **Baker**. Well, Senator Chafee, our original proposal, you will recall, contained a health care cap which we felt might be helpful in terms of tending to prevent the recurring increases in health care costs, which we are experiencing in this country. And from that standpoint, it might be good policy.

But we take note of the fact that a similar proposal has been before this committee for 4 years, and it would appear that that's an idea whose time has simply not come. It is still our view that to some degree at least there ought to be some taxability with respect to fringe benefits. This is a very modest amount, and would simply establish the principle.

Senator **Chafee**. But this committee hasn't resisted putting a cap on the educational benefits, which we have and you removed it.

Secretary **Baker**. Well, it certainly has resisted the health care cap fairly vigorously. And this was deemed to be the only alternative proposal that might have some possibility of being receptive to this committee as well as to the Ways and Means Committee over in the other body.

The fact of the matter is, while we might have preferred what was in our original proposal as a matter of policy, we simply did not feel that the proposal had any chance of passage.

Senator **Chafee**. Well, I don't quite get your rationale in saying that we've resisted the health caps so therefore you took the cap that we had already on the education.

The **Chairman**. What cap on the education are you talking about?

Senator **Chafee**. Well, there's a limit of $5,000, which you removed.

Let me talk about capital gains for a minute. The capital gains reductions which have brought us down to 20 percent have been enthusiastically received in the Nation. Indeed, we've had testimony from the venture capitalists and the high-tech people those who are the primary beneficiaries of investment of this nature. While they are always glad to see the rates go lower than 20 percent, there wasn't greath thrust for that. It seems to me that this is going a little too far. What are you going to accomplish by going down another 2½ points?

Secretary **Baker**. Well, we think that to some degree, Senator, it will increase incentives. It will increase entrepreneurship. It will increase capital formation. And for the same reason we put it back in. We felt it was appropriate where you had an exclusion of roughly 30-percent exclusion in prior law, when you reduce the maximum rate from 50 to 35, you are only talking about a 15-point differential. So we simply thought it was appropriate to go to the 17½-percent effective rate.

When I was up here before on confirmation, Senator, many members of this committee were quite concerned about Treasury 1 and its tendency to discourage capital formation and discourage investment. We've heard several Senators here today say they hope this proposal will encourage investment and that sort of thing. We think this proposal does that.

Senator **Chafee**. Well, let me just say that I was one of those who was disturbed about Treasury's removal of the differential between ordinary income and capital gains. I think you are doing the right thing to keep that differential in this proposal. There is no suggestion of going back to the Treasury 1 on this. I just was wondering what you have got in return for the possible revenue loss with 2.5 percent on going down a little further.

Thank you.

Thank you, Mr. Chairman.

The **Chairman**. Senator Bentsen.

Secretary **Baker**. May I just finish the answer on that?

The **Chairman**. Yes.

Secretary **Baker**. Senator Chafee, there is no revenue loss here to speak of. The elimination of capital gains in Treasury 1 was a revenue loser. And putting capital gains back in does not lose revenue.

The **Chairman**. Senator Bentsen and then Senator Symms.

Senator **Bentsen**. Thank you, Mr. Chairman.

Mr. Secretary, we have had a very substantial increase in our trade deficits. One hundred and twenty-three billion dollars last year. Looks like it is going to $160 billion this year. I'm deeply concerned about the competitiveness of America, about the fact that we've had 365,000 manufacturing jobs that we have lost in this country in the last 4 years, about the erosion of the manufacturing base of this country. Time and time again, we have taken major actions in the country with no consideration for what they do for trade, or what they do for the competitiveness of America.

I look at the deregulation of AT&T, which opened our telecommunications markets to imports, and the fact that the administration did not even deem it necessary to send a witness to appear before us as we brought up that telecommunications bill.

I contrast that with the situation where Japan privatizes Nippon Telephone & Telegraph and gives very careful consideration as to how it will affect trade.

And I see before me a tax bill that really increases the tax on the goods-producing part of our economy, our manufacturing base. And that concerns me very much.

I don't see the consideration that has been given to competitiveness in America in this tax bill. I see a lot of economists that would label this a consumer tax bill, something to encourage consumption in our country and we have a propensity for that already. The bill would reduce taxes on individuals by $132 billion over 5 years, and raise them by a like amount on businesses.

What consideration has been given to competitiveness and the trade deficit in this tax bill?

Secretary **Baker**. Senator Bentsen, quite a bit. And I think that in terms of trade competitiveness, we have come—let me suggest—light years from Treasury 1. And that, after all, is where we had to start looking.

Now I would argue, sir, that——

Senator **Bentsen**. Well, I think you start looking at what the current tax bill is—and compare that with your 1981 bill, which was for capital formation and sold on that basis.

Secretary **Baker**. You are suggesting that we ought to look at current law. And I think that's quite appropriate. And it seems to me that what we have here is a proposal that will decrease the overall tax rate on capital in this country. We will end up with a

Tax Code that is very competitive with respect to the code of our trading partners. And let me interject here that I share your concern for the trade competitiveness of this country because I also see us going down the tubes in terms of competitiveness.

But I really don't think, Senator Bentsen, that the problem lies with the Tax Code. I know that the cure doesn't lie with the Tax Code. It lies with the deficit problem. It lies with the high dollar. And those are the things, it seems to me, that we should be attacking and focusing on.

Senator **Bentsen**. Mr. Secretary, I agree with you—but the Tax Code is a part of it. It's all part and parcel. All of these things fit together. It's a composite. And time and time again we take actions where we do not give sufficient consideration to that competitiveness.

Since my time is limited and I didn't make a lengthy opening statement, I would like to go ahead with some of my other questions.

Mr. Secretary, one of the points that you made was concerning the cut in taxes to middle income. My concern is that the way it is set up with about a third of our people not renting, not owning their own home but renting, and they be given a 5- or 7-percent tax cut, whatever that might be, the way the tax bill is written up and the way it applies, it seems to me, from the studies I have seen thus far, that over a period of 4 or 5 years, you are going to have a very substantial increase in rents. Where that person might be saving $200 on taxes, he could find himself paying another $500 or $600 in rent. How would you answer that?

Secretary **Baker**. Well, sir, I would say that it's not at all proven as yet that we are going to see an increase in rents. It is, I suppose, a possibility that there will be some modest increase in rentals. But I don't think that on balance whatever we might see there is going to outweigh the benefits the middle class from this tax reform.

Senator **Bentsen**. Well, I see them having an actual deficit in what they would finally have in take-home money over that period of time.

Now, one last question, if I might. You were talking about recapture, and the situation where individuals or businesses would be charged with a recapture of accelerated depreciation that they had taken since 1980. And I can understand the rationale for that. You say they took the depreciation against a 46-percent tax rate in business, and, therefore, should not pay a tax on the related income at only a 33 percent rate, so you go back with a recapture.

I can understand that. You apply that only to depreciation. How do you differentiate from the number of other provisions in the Tax Code, such as the investment tax credit, R&D expenses? Couldn't you apply that same provision to all of the items in section 312 of the code? Things like trademark expenses, circulation expenses, completed contract accounting. How about the special bad debt reserves for banks? How do you just pick out depreciation? Doesn't the same rationale apply to all of these items?

Secretary **Baker**. Well, the same rationale might apply, Senator, with respect to some, but it would be extremely complicated to undertake to do that. And it was—one of the major reasons for this proposal was so that we could significantly liberalize the depreciation rule that had been called for in the original proposal. And, indeed, liberalize the depreciation rules from current law so that we could arrive at a point where the overall tax rate on capital in this country would be 20 percent less than it is today. That's why we key it to depreciation.

Senator **Bentsen**. Well, Mr. Secretary, the same rationale applies to all of those items, it seems to me. And you have chosen on the one hand to recapture that accelerated depreciation, but on the other you have chosen not to do so.

Thank you.

The **Chairman**. Senator Symms and then Senator Baucus.

Senator **Symms**. Thank you very much, Mr. Chairman.

Thank you, Mr. Secretary. Mr. Secretary, along the lines of the questioning that Senator Bentsen brought about, it just makes me reflect here that you are having a tax reform bill, but it really isn't that much of a simplification bill. I mean, it's going to be change. But with the depressed state of agriculture, how could we be talking about forcing the farming operations to go from a cash accounting system to an accrual system which could force them, in many cases, to have a higher tax liability because they won't be able to income average as they do now with their cash accounting. I mean, I just can't see how we could be—is it that big of an issue with respect to revenue neutrality?

Secretary **Baker**. No; I don't think so on the last part of your question.

Senator **Symms**. Good. We will change it then.

Secretary **Baker**. On the first part of your question, on the question with respect to simplicity, we really don't claim that we are doing a lot of simplifying on the corporate side. I think we've made that clear. But we are doing a fair amount of simplifying on the individual side.

On the question of moving from cash accounting to accrual accounting, we saw agricultural interests. We saw farmers. We saw ranchers. And, quite frankly, we were persuaded by their arguments and so we changed that provision so it applies only to operations that earn in excess of $5 million a year. I would suggest that operations that earn in excess of $5 million already keep books for their bankers on the accrual basis, and it's not going to be a great dislocation to them to move from a cash accounting system to an accrual accounting system.

There are a number of other objections, by the way, that agriculture had to this proposal which are out of there—interest indexing and things like that.

I would suggest that the vast majority of farmers in this country, farmers and ranchers, would benefit tremendously from this proposal.

Senator **Symms**. With respect to fairness, though, we have another problem in the Northwest and that is the fairness question that a timber owner who planted trees under one set of tax rules, but if we changed this law, we are going to double the tax rate on the timber owners. How are we going to work that out? I mean I realize it will go to 35 percent instead of 50 percent, as it would under Tax Code. I mean it will go to 20 percent. It isn't quite doubled. It would go from 20 percent rate under current capital gains rate up to 35 percent under this Tax Code. That seems like that is very unfair to those particular taxpayers.

Secretary **Baker**. Well, your original question, I think, was with respect to timber that had been planted under one rule and would be governed at harvest time by another. And I think the answer to that is that we would have there, and indeed propose there, perhaps the most liberal transition rule we have suggested in this proposal. And that is that any such change would be phased in over a period of 10 years.

Senator **Symms**. That's in the bill?

Secretary **Baker**. Yes. It's in our proposal.

Senator **Symms**. I'm sorry. I wasn't aware of that.

What's the transition rule for depletion allowance on minerals?

Secretary **Baker**. The depletion allowance would be phased out over 5 years, Senator, on all minerals except oil and gas stripper wells.

Senator **Symms**. We are probably going to get a lot of stripper wells.

Secretary **Baker**. Well, the definition is fairly well established.

Senator **Symms**. Well, they could turn the valve down just to get them under the net probably.

Secretary **Baker**. There are ways to take care of that, I think.

Senator **Symms**. Well, Mr. Secretary, one other question with respect to that transition rule thing. I mentioned to you—you weren't very excited about the idea—one day, that, why don't we have an election process and allow people 5 years to elect either under the current Tax Code or the new Tax Code so we would have a liberalized transition rule. I can't understand for the life of me why that would be that difficult for the Internal Revenue Service. If the new system is supposed to make it more simple, will all the people that go in the new system—it would be easier for the IRS to process it and the other ones stay under the system they are under until they can adjust their——

Secretary **Baker**. Well, we would have two complete Tax Codes we would have to administer at least for a period of 5 years, and that would be extremely difficult.

Senator **Symms**. Well, you are saying that the new system is going to be simpler for individuals. There would be a lot of them, I would expect, would elect the new system.

Secretary **Baker**. Well, we would hope that fully 50 percent of them would go to a return-free system, which would be permitted, Senator, if this proposal were enacted into law.

Senator **Symms**. Well, I will look forward to working some of these questions out. I tend to look at some of the complications that are in this bill—Senator Bentsen mentioned taxing the inside build-up of life insurance and several of those—indexing—and other things that are more complicated.

I can't help but think, Mr. Chairman, that probably the best simplification this committee could do for the country would be just to adjourn and leave everything alone for a few years, but I know that's not the drum beat we are marching to right now. But I would only say that I hope this turns out as well as the intentions are. And I know everyone has good intentions on it. But I do believe that revenue neutrality is going to make it very difficult to try to achieve the kind of tax reform we are after.

The CHAIRMAN. Senator Baucus and myself, and then Senator Wallop and Senator Heinz.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Secretary, when you gave your statement, I listened to it fairly closely and I didn't hear any words in your statement explaining the proposal about America's international competitive position. You did address that question, but it was only in response to the questions asked by Senator Bentsen.

I'm just curious that given your own words, that is, our competitive position is going down the tubes, why doesn't your statement, why doesn't the proposal, more directly address the American competitive position. And following up on that slightly, I see lots of analysis on how the burden might be shifted from some taxpayers at some bracket to some other taxpayers or the burden might be shifted away from individuals to corporations. But I don't see any analysis, I don't see any thoughtful thinking as to how precisely this proposal will affect the U.S. competitive position either overall, how various tax systems compare, or, third, how it might affect different sectors of American economy. That is, some industries differently compared with other industries as they are hurt or not hurt competitively in trade with other countries in the world.

Why is that? Where is the analysis that looks at our competitive position?

Secretary BAKER. Well, Senator, I thought I explained that in answer to Senator Bentsen's question. I share your concern as expressed in your opening statement about our competitive position, but I really do not believe that the Tax Code is the place to try and correct that. I think the problems are more fundamental. I do think we need to correct them, but I think they reside in other areas.

And tax reform should not be used, in my view, where we have a Tax Code that is competitive with the codes of our trading partners. And this one would certainly be competitive in our view, and I so stated.

I don't think that we should set about the business of trying to use tax reform to correct our trade imbalance. Now I don't think we should use it to exacerbate it either.

Senator BAUCUS. On that last point, there are lots of industries, American industries, that are very heavily capitalized. Very capital intensive. The mining industry. The forest products industry. Smokestack industries in America. Very capital intensive. Because of the elimination of the investment tax credit, because of stretching out depreciation provision, it's clear that those industries are going to be more adversely affected than some other service industries, for example.

So I'm wondering what do you say to them. Are they going to go down the tubes? Because it's clear that they are going to be hurt compared with other industries in America which are not as heavily capitalized.

Secretary BAKER. You are really saying that this may not be as favorable a proposal to those industries.

Senator BAUCUS. That's correct.

Secretary **Baker**. And, indeed, my statement says that, if you will look at it, I believe, Senator Baucus.

Now I think what you say is overall we will have a much more efficient economic system in this country; we will have a system under which the overall tax rate on capital is 20 percent less than it is today; and there will be instances where a particular company will not fare as well under this proposal as they fare under the current tax system.

Senator **Baucus**. This is my concern. I hear the noble objective of neutrality. That does sound good. But I think it's also true that the industries, as I outlined, are hurt more and not helped as much on a comparative basis as are other industries in America. And these are the ones that are more heavily engaged in international trade. Now the semiconductor industry, too, is becoming very capital intensive. And it's clear to me that it's going to make it more difficult, not less difficult, but more difficult for those industries to compete—forest products, mining and the other ones that I named as well.

And I'm wondering if you have done analyses that bear out your assertion that they are not hurt competitively, or have you not done that analysis.

Secretary **Baker**. I think that what I would say is that overall the U.S. economy and the U.S. trade position will not be adversely impacted when looked at overall. We will have a more efficient economic system. We already have a competitive tax system. We will have a lower overall cost of capital.

Elimination of ITC's is what is driving, I think—the point you are making, which I concede is a valid point, Senator. But we are in a situation today where a number of companies have negative tax rates as a result of what we did in 1981. And we are simply trying to correct that because you cannot have overall tax reform when you have a situation like this.

Senator **Baucus**. But I also hear you say very candidly that the place to address the problem of many American industries going down the tube is not the Tax Code. That's what you say. I beg to differ with that. I think there are ways to encourage savings and other things that can be done to include the cost of capital.

But I also don't see this administration working hard to address our declining competitive position in other areas. For example, we don't have a new trade representative. The USTR has not been sent up here. It's been over 2 or 3 months since this country has had a trade representative. And I don't see the administration working in other areas; that is, the nontax areas, trying to address our declining trade position. I'm just suggesting that the solutions are several. They include getting a USTR so we have got an aggressive advocate fighting for America. But they also include working the Tax Code to help make America more competitive.

Secretary **Baker**. Yes, sir.

The **Chairman**. Mr. Secretary, I want to come back to this idea of revenue neutrality, so I understand the parameters that we are working within.

You said $4.7 trillion, that's our total expected revenues over the next 5 years.

Secretary **Baker**. Receipts; yes, sir.

The CHAIRMAN. Receipts. And given plus or minus 1 percent—Senator Moynihan rounded it off at $50 billion, but that's a fair rounding. You are saying that any bill that comes out that is—in terms of fair estimation, plus or minus $50 billion, off of the 1 percent 4.7 mark is a revenue neutral bill.

Secretary BAKER. Well, I'm saying, Mr. Chairman, that that's the way we look at it at the Treasury Department. That if you can get within 1 percent, that's pretty good revenue estimating.

Now if you are asking me would the President agree to a proposal that raised $50 billion in revenues with some sort of a new broadbased tax or something like that, I'm certainly not suggesting that.

The CHAIRMAN. You are not sure if that falls within the definition of revenue neutrality.

Secretary BAKER. I'm sure that probably falls outside.

The CHAIRMAN. Well, you sensed what I was driving at.

Now, second, in your statement—and I've noticed from time to time in the papers the definition of "economic income"—and in your chart you have got family "economic income." And I discover that it includes lots of things that the average Jane or Joe would never think of when you say how much do you earn, what does your family make. For example, one of the things you have got in it is the rental value of the house that you own. And if Mr. Pearlman wants to come up to the table, I will be glad to have him because I want to make sure that economic income doesn't somehow skew the statistics so that when we go out to make speeches to the average audience that we are not talking about different things.

Secretary BAKER. Well, I've had this question before, Mr. Chairman, and I'm told that it doesn't skew the statistics, and that we use economic income because it's difficult to use adjusted gross income where we are calling for the kind of changes that we are calling for.

The CHAIRMAN. Well, it does include—for example, the rental value on a home. Let's say you own a $100,000 home and it would rent for $500 a month. You presume, therefore, the person has the $6,000 more income when you define economic income.

Secretary BAKER. Economic income. That's correct.

The CHAIRMAN. And going down the list, it includes the income on IRA and Keogh contributions. It includes the untaxed employer contributions for pension, health and life insurance, profit sharing, and other benefits. It includes the untaxed benefits on unemployment comp, workers comp, SSI, veterans' compensation, Social Security, railroad retirement, and so on. I have no idea whether that skews it from just the average Jane or Joe when they say I make $15,000 a year, and they are thinking of their wages. But, indeed, it does include all of these things, which all of those subjects are common to us. We know them. But we don't normally think of them in income when we talk about them.

Secretary BAKER. That's right. Now, Mr. Chairman, that applies only to the distributional tables. It does not apply to any of the revenue estimates.

The CHAIRMAN. It applies when you say economic income in thousands and then the percent reductions. That's where you are talking about distributional.

Secretary **Baker**. Yes, sir. That's correct.

The **Chairman**. This is what I am curious about. When you have families of $50,000 or more, you've got a reduction of 5.8 percent and yet we see in the papers an argument that the reduction for those making $50,000 or more is a higher percentage than that. And I'm curious what the difference is between the reported percentage that we see and the 5.8 on the economic income.

Secretary **Baker**. I'm going to have to let Mr. Pearlman answer that question for you, Mr. Chairman.

Mr. **Pearlman**. Mr. Chairman, I got the last part, but not the first part of your question. Do you mind asking it again?

The **Chairman**. Sure. On the chart that the Secretary used, percentage tax reduction for different economic classes, all families 7 percent. Families less than $20,000, 18.3; families $20,000 to $50,000, 7.2; families $50,000 or over, 5.8. This is for family economic income. And yet the statistics I have been seeing in the paper is that the reduction for families of $50,000 or over is percentagewise a higher reduction than for those $20,000 to $50,000. And I'm curious why when we talk about economic income the percentage is less, but at least the report of percentage is higher when we are talking about just income. I don't know if they are talking about adjusted gross income or what.

Mr. **Pearlman**. One of the difficulties, obviously, we have with articles that appear in the paper is we don't know what they are using in making their analyses. But I think we could demonstrate that an adjusted gross income analysis would show essentially the same difference.

The **Chairman**. Well, I hope so. I just don't want to get blindsided or mousetrapped, Mr. Secretary, by talking about one thing and having somebody say, well, I don't care what you say, but I don't get any value, I don't earn any money out of the house that I own and for you to use that to put me into a higher income tax bracket is unfair.

Secretary **Baker**. Well, I think, Mr. Chairman, if I may say so, that economic income gives you a more accurate estimate. And that's the reason it was used according to our tax policy people.

So I don't think there is a risk of that happening.

The **Chairman**. Last question. You have shifted taxes in this bill over to business to some degree and used the revenue to lower rates. And I have no quarrel with that. Would you have any objection if this committee could come up with a further shift on taxes on business and use that money to further lower the rates?

Secretary **Baker**. Well, Mr. Chairman, we think that it might create some distributional problems if we lowered the top rates further. We are already being accused by some of not being fair to the middle class because there is one rate, one bracket, up there that gets a 10.7-percent reduction. While it's true that the corporate share of the tax burden has been declining——

The **Chairman**. Is that a 10.7-percent reduction, again, based on economic——

Secretary **Baker**. Percentage tax reduction based on economic income.

The **Chairman**. For families of over what?

Secretary **Baker**. 200,000.

The CHAIRMAN. All right.

Secretary BAKER. While the percent that corporations are paying as a share of GNP has, in fact, been declining in recent years from about 4.3 percent in 1960 to 1.6 percent today, we are moving that back up as a result of this bill to about 2.8 percent. That contrasts with historical 25 year figure of about 3.8 percent. So, there would not be a lot of room there before you get business taxes out of kilter with what their share as a percentage of GNP has been historically. So I think that might present us with some problems.

The CHAIRMAN. Senator Heinz and then Senator Long.

Senator HEINZ. Mr. Chairman, thank you.

Mr. Secretary, one of the issues I raised in my brief remarks at the beginning was the extent to which you could predict or justify justify this proposal in terms of increasing savings. The United States and its citizens and businesses save at one of the lowest rates ever recorded in the industrialized world. The net savings rate is about 5 percent, approximately the size of the Federal budget deficit.

It's generally acknowledged that individuals, when given more money, are less likely to save it and more likely to spend it. Businesses, on the other hand—almost every economist agrees on this—are more likely to save it, and, therefore, have it available for investment either for themselves or for others by depositing it in the bank or buying securities or so forth.

Now in your analysis, you point out that in the table entitled "Change in Receipts" that each and every year starting in 1987 there will be somewhere between $26 to $32 billion that goes to individual rate reduction and somewhere between 23 and 26 additional receipts from additional corporate taxes. If it is true that individuals tend to spend on consumption and corporations tend to save better than individuals, why isn't the Treasury proposal going to result in lower savings in the economy, and, therefore, less money for investment and jobs?

Secretary BAKER. Senator Heinz, when I was up here for confirmation, you made this very same point to me. And I would like to think that we considered the criticisms that you pointed out, and we made significant changes from the original Treasury proposal which will encourage both savings and investment.

Even if you accept the point of view that increased corporate taxes reduce investment, and lower individual taxes stimulate consumption, which I'm not sure has been totally proven—but let's assume for the moment that that's the case—we've come up with a revised depreciation schedule which will lower the overall cost of capital from current law. We've reduced capital gains—I mean we have included capital gains back and the effective rate will be lower than it is today and we have preserved the graduated rates for small businesses.

I think that you have to look at more than the shift in the burden from individuals to corporations. You've got to look beyond that, and that you have got to look at still other things in the package.

Senator HEINZ. I'm willing to do that, but I'm just trying to—and maybe your proposal does lower the overall cost of capital. Maybe it doesn't. I don't know yet. And we are going to have a lot of witnesses. I would agree with you that you have substantially modified and improved, from the point of view I expressed to you many months ago, this proposal. I don't want to argue that with you, Mr. Secretary. I agree with you.

But I'm just trying to get at a very simple issue which is: Are we going to have more savings generated as a result of this proposal? And if so, why?

Secretary **Baker**. Well, I think we will, because we are going to reduce the attractiveness of tax shelters. It seems to me that's going to increase investment for economic reasons. We are increasing the amount that can be put into IRA's. We are lowering tax rates, which ought to increase savings and investment. All of that money is certainly not going to go to consumption, even if you assume your thesis.

So I think the answer is yes. Lower tax rates are going to increase our labor productivity.

Senator **Heinz**. Mr. Secretary, since we have got a limited amount of time and I have two other questions I want to ask you, I guess I will submit a follow-up question to you on the record which is simply to deal with the issue of how given corporate and individual propensities to consume and save—what you have said is true. We can get into that more technically. I have two other questions.

One I think is a brief one. Would the Treasury consider a tax increase which the President is against and we are all against—would the Treasury consider it to be a tax increase if the Finance Committee decided, again, on a totally revenue neutral basis—maybe even within a tighter definition than you have given us—to supplant one tax with a different and new tax. Let's suppose that we simply wiped out all payroll taxes on individuals and maybe on corporations, too, and raised an equal amount of money by some other source. Would that be a tax increase if that was revenue neutral?

Secretary **Baker**. Yes. Yes, sir, I think it would be; particularly, if it was some sort of a broad-based tax.

Senator **Heinz**. Even if it eliminated another tax and was revenue neutral?

Secretary **Baker**. Well, we really believe, Senator, that it's preferable that tax reform be accomplished within the confines of the current system.

If, for instance, your question is: Would we support a value-added tax in lieu of some other provisions, I have to tell you that I don't think that the President would support that.

Senator **Heinz**. I'm not asking with respect to a specific individual proposition.

Secretary **Baker**. Well, I can't answer it carte blanche. I would have to see what the proposals were, and, obviously, we would have to discuss it with him. But generally speaking, I think he would be opposed to that sort of an approach.

Senator **Heinz**. My time has expired. I hope we will have some time for follow-up questions.

The **Chairman**. Senator Long and then Senator Bradley.

Senator **Long**. Mr. Secretary, I hope you understand that the fact that I and most Democrats made no opening statements did not mean that we have any less high regard for you than do our colleagues on this committee. My thought was that the sooner we let you get on with your statement, the sooner the people were going to hear what they came to hear, namely your statement, not ours. I suppose if this had been on live coverage on the VHF channels, you would still be hearing opening statements before the committee and we still would not have heard the Secretary of the Treasury.

First, let me compliment you for the way you have handled your job since you took over as Secretary of the Treasury. I think you have done an outstanding job in studying the recommendations before you, keeping the best of them and changing those that were not the best. I believe the country is indebted to you for what you have done up to this point.

It is a fact that under the Reagan administration the President has supported and Congress has enacted and sent to him for signature, and he has signed, several measures which have moved forward the concept of employee stock ownership. In my discussions with the President and with you, you have concluded that this administration under your leadership does favor a trend toward greater employee ownership and that you would like to see that trend continue. Would you favor us with your views on that subject?

Secretary **Baker**. Well, Senator, I hope we made it clear to you that we support the concept of employee stock ownership. I know we have a number of changes in the proposal from Treasury 1 which the President supports, which I indicated in my opening statement, and which I hope that you support.

Senator **Long**. I'm pleased, Mr. Secretary, by the development that has taken place since you took over as the Secretary of the Treasury. I have no criticism of any decisions that you have made, certainly any decisions that I've had a chance to discuss with you on that subject.

However, I've seen a memo by one of our staff experts that indicates that there are some other provisions that we have not had occasion to discuss which would have an adverse effect on employee stock ownership. I would hope that in the future, whenever you have the opportunity to focus on those matters, that you and I can work together to see that we don't unintentionally reverse a trend that I believe both you and I would like to encourage.

Mr. Secretary, I'm sure you are aware that several of our friends in the timber industry are not too happy about the President's tax proposal insofar as it deals with them. On their behalf I want to ask you: Do not most other countries have special rules relating to the taxation of timber?

Secretary **Baker**. Senator Long, I really can't answer that. But hang on just a minute. Maybe somebody here can.

Senator **Long**. You can provide it for the record, Mr. Secretary.

Secretary **Baker**. Yes, we will do that if it is all right.

Senator **Long**. Fine.

Secretary **Baker**. I understand Canada does have a special provision.

[The information from Secretary Baner follows:]

OTHER COUNTRIES PRACTICES REGARDING TAXATION OF TIMBER

Several major timber producing countries provide tax or other incentives to the timber industry. For example, Canada permits forestry management costs, which are really capital costs, to be treated as current expenses for tax purposes. The Canadians cannot, however, treat profits from timber sales as capital gains, as U.S. companies can under current law. Thus, an International Trade Commission study recently concluded that the Canadians face higher effective tax rates than their U.S. counterparts. Canada also provides various other aids, such as grants, loans, and loan guarantees, to forestry and other industries through its Department of Regional Industrial Expansion. Brazil allows expensing of forest investment and offers a reforestation credit for new plantings in targeted areas. A land improvement income tax deduction for individuals reduces their effective tax rates to near zero. Lumber producers also benefit from the reduced property tax and value-added tax rates for all agricultural producers in Brazil. The smaller timber industries in Europe and Oceania also receive various tax incentives, according to a recent survey by Arthur Andersen and Company. Some major Asian producers actually pay additional taxes, though. Indonesia, Malaysia, and Philippines assess royalty and export taxes on timber.

Senator **LONG**. The timber producers make the point to me that they are a resource of the country that can do much to improve our balance of payment because of the favorable growth conditions in this country. They ask whether the changes in the law being advocated in this bill would not cause them to pay a much higher rate of tax and tend to reverse what could be a very favorable trend in the development of this industry to help reduce our unfavorable balance of payments and improve our international competitive condition. Would you give us your thought on that?

Secretary **BAKER**. Senator, I can't speak to the extent to which it might—these changes alone might adversely impact the trade competitiveness position of the United States as far as forest products are concerned. But, obviously, if capital gains for timber is no longer permitted and if preproductive expenses with respect to standing timber are going to be capitalized, I suppose we would have to accept the argument that there would be an added tax burden as far as that industry is concerned. I would simply have to accept that.

Senator **LONG**. Thank you, Mr. Secretary.

The **CHAIRMAN**. Senator Bradley and then Senator Roth.

Senator **BRADLEY**. Thank you very much, Mr. Chairman.

Mr. Secretary, first of all, let me salute you and also the President for making this the No. 1 domestic priority of the President's second term.

I agree with that ordering of priorities.

Let me also say that I think that the President set the right theme in his speech a week or so ago when he talked about tax reform. Tax reform does mean greater fairness, economic opportunity, economic growth, and economic security for individuals and families. And I think that he was doing what he should do to talk about that to the American people because they have to either understand that or tax reform is not going to happen.

Let me also say that in your previous appearances before the committee you have, in answer to specific questions, said that you would not support nor would the President sign a bill that was not revenue neutral. And your definition today is clarifying. Nor would he support a bill that increased the relative tax burden on middle-

or low-income people, and that you wanted the lowest rates to the greatest number of Americans.

Now it's with those criteria that I think we will look at the tax reform proposal that you have submitted. To be specific, I would like to take fairness as the first criteria, because that's the President's own criterion. And I'd like to take the capital gains rate, the cut to 17½ percent. Now 75 percent of the benefit of capital gains goes to people with incomes of more than $100,000. How does that meet the criteria of fairness?

Secretary **Baker**. Senator Bradley, I think you have to look at this proposal in its entirety. I don't think you can look at one item and say this goes—most of the benefits of this would go to upper income taxpayers, therefore, it's not fair. You have to look at what we are doing for everybody—middle income and particularly those at the low income scale. We are taking 2.5 million Americans off the tax rolls who earn less than $15,000. I mean I think that as far as capital gains is concerned there is strong, serious concern on the part of many Members of Congress, both in this committee and Ways and Means, with respect to our trade competitiveness position, with respect to capital formation and investment. That's why we put capital gains back in. We want a program that's profairness and progrowth, and this is a progrowth element.

Senator **Bradley**. We've had a number of witnesses come before the Finance Committee in just the last year and say quite clearly that the capital gains differential does not have a substantial impact on overall savings rates or on capital formation. So my question to you is: What is the evidence that you have that would lead you to propose to cut the capital gains rate even lower than what it is today?

Secretary **Baker**. We think, Senator, that the capital gains incentive is a fundamental part of the entrepreneurship that has driven this economic engine of ours all these years. We believe that as a fundamental belief.

Senator **Bradley**. It is more a belief than something you actually know as a fact.

Secretary **Baker**. Yes, sir.

Senator **Bradley**. In other words, there is no persuasive evidence, is there? It's a belief.

Secretary **Baker**. No. I think we could come up with evidence. But we believe it so strongly we haven't gone out and tried to order an appraisal.

Senator **Bradley**. If you could provide that for the record, that would be very helpful.

Secretary **Baker**. Yes.

[The information from Secretary Baker follows:]

With respect to the preferential rate accorded capital gains, three points ought to be made. First, the preferential rate provides an offset to the taxation of inflationary gains. Second, it offsets the impact of the progressive rate structure on gains that accrued over a period of time, but are realized in a single year. Third, it reduces the significance of "lock-in" effects, thus improving the allocation of capital.

With respect to growth rationales for the favorable capital gains treatment given in the President's proposals, two broad points need to be made. First, favorable tax treatment of capital gains does, all else constant, lower the effective tax rate on aggregate capital. This, in turn, can be expected to stimulate aggregate savings, investment, and economic growth. While the capital gains provision is only a small part of the President's proposal, it does contribute to the pro-growth nature of his proposal. See "Report to the Congress on the Capital Gains Tax Reduction of 1978" for further information. The preference for capital gains in the President's proposal may also have an expansionary effect on new entrepreneurial activity generally, and especially activity in risky, high technology areas. Favorable tax treatment of capital gains stimulates risky, new entrepreneurial activity because it lowers the relative effective tax rate applied to income generated by such activity. There are three important effects (for a more detailed discussion, see the aforementioned report to Congress). The first stems from the increased incentive to invest equity in so called "natural-deferral" activities, of which investment in new high-tech firms and new entrepreneurial activity, in general, is one. The second is caused by the effects of favorable taxation of capital gains on the supply of "venture-capital," an important source of external financing for new and small innovative enterprises. Investment of venture capital from sources not directly benefiting from favorable capital gains treatment may also be increased indirectly as more potentially successful ventures are discovered. Third, the effect of favorable capital gains taxation on the incentives of potential insider/founders directly involved in new, often high-tech, enterprises may be significant. On the one hand, these insiders are important sources of financing for new, small enterprises. For example, about 19 percent of external equity in small, high-tech enterprises is supplied by these entrepreneurs.

There are, then, reasons for supporting the favorable tax treatment of capital gains. Of particular importance is the theoretical and empirical evidence suggesting that favorable capital gains taxation is an offset for the taxation of inflation-induced nominal gains.

Senator BRADLEY. Let me move on to another question of fairness. In the bill, you saw fit to make some substantial changes in the energy area from Treasury 1. You put back in expensing of intangible drilling costs and percentage depletion for stripper wells. Now according to the Treasury's own analysis, half of the benefit of the intangible drilling cost deduction goes to individuals who make more than $100,000. And, in fact, 31,000 taxpayers who make more than $100,000 will have an average benefit of $28,000 from the intangible drilling cost deduction. How is that fair?

Secretary BAKER. Again, Senator, I think you have to look at this proposal in its entirety. In the first place, you are comparing it to Treasury 1, and I think that really in terms of what the effect is going to be should be compared to what taxpayers are faced with under current law. If you look at it under current law, what we are saying is the energy industry ought to sit at the table of tax reform. And we are calling for the repeal of the depletion allowance, except for strippers. That's a very symbolic thing. It's something that has been fought over up here in these Halls for many, many years. We are also calling for the strengthening of the minimum tax, both corporate and individual, with respect to intangible drilling deductions so people can't zero out on intangible drilling deductions.

So I think that the changes, when you consider the national security interest involved and you look at the proposal in its entirety, are fair.

Senator BRADLEY. Well, I just want to clarify for the record that both on the capital gains and the intangible drillings cost deduction, the rationale that you offered to justify their inclusion in the package, was other than pure fairness. And I understand that.

Secretary BAKER. Partially growth, yes, sir. In one case, growth and in one case national security.

The CHAIRMAN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

The CHAIRMAN. And then Senator Durenberger.

Senator ROTH. Again, Mr. Secretary, there are two things that deeply bother me about the tax proposal. First is that it seems to me, as I read your charts, is that it tends to soak the middle class. It, in effect, is sweeping the tax burden from the ends of the economic scale to the middle. And I think that is very bothersome and must be corrected, or an explanation as to why that is not so.

And, second, I agree with Lloyd Bentsen and the others who have said that in effect we have a consumption and not a savings bill. I think the most important thing we can do to tax reform is to create an environment of growth, of jobs, and that means savings. The Japanese have shown that their 17 to 20 percent savings rate is the means of building the most modern industrial base in the world.

So let me go back just a minute. This is your own chart. It's chart 14. And it shows that the taxes will be increased on 17 percent of those making $15,000 to $20,000. If you go to $20,000 to $30,000, there's a tax increase for 22 percent of them. Thirty to fifty, twenty-eight percent. Fifty to a hundred thousand, thirty-three percent are going to experience a tax increase. So what bothers me, Mr. Secretary, is it seems to me that we are penalizing in many ways our most productive part of the community, and that that ought to be corrected.

I realize that it may take detailed analysis so I would ask you, if you would, to provide for the record who these people are and why their taxes do increase.

But I want to get on to the question of savings because I think that's critically important. I think it's important that we build on the IRA's so that individuals will begin to save more. I congratulate you on what you do with the spousal IRA.

But what bothers me is your answer earlier to Bob Packwood that you would not consider a new tax revenue, a new tax revenue such as a business transfer tax, which, Mr. Secretary, could be used to very substantially reduce the marginal rates. For example, if you had a BTT at 10 percent, you could reduce the top marginal rate from 50 to 25 percent. You could have the same brackets as the President's proposal with rates set at 15, 20, and 25 percent. The BTT, could also be imposed on imports legally under GATT so it helps trade.

And I would also point out that it would help on employment because under our proposal, we would permit this tax to be credited against Social Security or FICA.

So my question to you is: Why can't we consider some new tax revenue? Keep it tax neutral, but use it to reduce marginal rates, use it to level the trading field. Why should we rule that out?

Secretary BAKER. Senator Roth, I think it would be the President's view that he would be opposed to any new broad-based tax such as you have suggested because it really increases the potential for enormous growth in the size of government. It would be a tremendous engine for revenue raising, if you will, and that's been the basis on which he has opposed that type of tax in the past. And I simply think that would be his reaction.

I think we should make every effort to try and stay within the framework of the current system, if we can. Now I don't want to eat into your time, but I really do want to answer your question about soaking the middle income group.

Senator ROTH. I just want to point out that this is your chart; not mine.

Secretary BAKER. I'd like you to look at the top part of the chart, if you would, Senator, and take a look at the cuts that those people get, too. And also look at this chart right here which shows you the percentage reduction that the middle income gets versus what the upper income gets.

Senator ROTH. But let me answer you. Your own chart shows that those who make $30,000 to $50,000, 28 percent of them, 28 percent are going to face a tax increase. The same is true in the $20,000 to $30,000. Those aren't rich people. Some 22 percent are going to face a tax increase. Fifty to a hundred thousand. No Senator will admit he's rich. That is a 33 percent—33 percent of that group will face a tax increase.

Secretary BAKER. Let me just say this. We are going to get you the figures. I'll be delighted to do that.

But I would really—I will predict to you, Senator, if I might, that those figures are going to show that the people who get those tax increases are, for the most part, people who are taking advantages of deductions and credits and exclusions.

Senator ROTH. Those $20,000 to $30,000 are taking advantage of tax shelters?

Secretary BAKER. I think you are going to find—I think those are the people in that bracket who will be itemizing their deductions. But we will get you those figures.

[The information follows:]

CHARACTERISTICS OF TAXPAYERS WITH TAX INCREASES UNDER THE ADMINISTRATION'S PROPOSAL AND SOURCES OF THE INCREASES

Taxpayers with net increases in tax liability under the proposal are, by definition, those for whom the tax-reducing elements of the proposal are not large enough to offset the effects of the base broadening elements. While the increases in the personal exemption and the zero bracket amount and the rate reductions apply to all taxpayers and work to reduce taxes, the limitations on deductions, exclusions, credits, and other forms of preferential treatment tend to increase the taxes only of those currently benefiting from those special provisions of current law.

More specifically, returns with tax increases were much more apt to be itemizing deductions than were returns with tax decreases. Overall, slightly fewer than one-third of all returns itemize, whereas nearly three-fifths of returns with tax increases itemize. And this tendency was true at all income classes as well. For example, only about half of the returns with AGI between $20,000 and $30,000 itemize, but nearly seven-eighths of the returns with tax increases itemize.

Taxpayers that would experience substantial tax increases (increases in tax liability that exceeds 1 percent of AGI) also tend to have above-average incomes but pay below-average percentages of that income in taxes under current law. Middle-income taxpayers are less likely to fall in this category than are high income taxpayers.

The major sources of the tax increases differ among income levels. For middle income taxpayers with increased liabilities under the proposal, families with incomes between $20,000 and $50,000, the full inclusion of unemployment compensation and the limitations on itemized deductions are the major sources of increased tax liability. For low income taxpayers, income below $20,000, the full inclusion of unemployment compensation, the replacement of an elderly exemption with an expansion of the elderly credit, and changes in the treatment of special retirement plans are the main sources of tax increases for those taxpayers with increased liabilities. For high income taxpayers, income over $100,000, limitations on itemized deductions, elimination of the investment tax credit, and the repeal of percentage depletion made the major contributions to tax increases.

Senator **Roth**. Mr. Secretary, let me point out again. I differ. If I could just take a second longer.

I differ if they take a deduction like State and local from, as I say, some agricultural mango tree shelter. But, again, I would urge you to look at some of these other revenue bases because I think we can help trade and do some of the things we have got to do with respect to making this a savings bill.

Thank you, Mr. Chairman.

The **Chairman**. Senator Durenberger and then Senator Armstrong.

Senator **Durenberger**. Mr. Secretary, I agree the bill is simple like 10-10-10, 10-5-3; it's 35, 33, 2,000. And we can all understand that. But I'm looking forward to 6 months of debate now that we know the time frame we are working on.

I would like to deal with the other, easy issue which is the issue of fairness. And I'm not sure whether that ought to be a principle here or not, but you offered it up as a principle so we all are going to deal with it.

The President feels fairness—that the lower the rate, the fairer the burden. We can all agree with that. The broader the base, the fairer the tax. We ought to be able to agree with that. I agree with it because I was in the 44-percent marginal bracket this year and George Bush was in the 12½ percent. He had a higher income than I did and I want to get at him. So that's not half bad.

You say fairness is—savings is good. Be protected in some way by the tax policy. That's fair. Capital investment is also good and to be protected. So is consumption. I'm not sure that we can get all three of those things done, but I think it's fair for us to try.

Next, I think there will be a question around here about the fairness in taxing work rather than income. We are not reforming the Nation's tax system. We are only reforming the income tax. It's not clear to a lot of people.

The Social Security tax, for example, by the end of the 4- or 5-year period encompassed by this bill will be $7,894.80. That's just the payroll tax on folks that go to work and have to pay into Social Security. It doesn't include unemployment comp. We aren't affecting that part of the law.

We are reducing the tax on incomes while we permit the tax on work to increase. This bill, the result of this bill, again, with its changes raises the issue of fairness in the way in which cash flows to an individual and it will determine the size of one's interest subsidy on noninvestment debt. And I think the problem—and in the second line of questioning maybe we ought to deal with it.

But somebody who has $50,000 a year in cash flow can only buy so big a house where somebody with $500,000 can afford a much more substantial home or a smaller house and a whole lot of other borrowing.

It is still a nation, after this bill, in which Lee Iaccoca will continue to receive a $3,000 a year tax subsidy for his health insurance while self-employed people in Detroit get zero, and in a nation in which 10,000 children will die each year from poverty.

It will continue to be a nation in which national defense is premised on tax subsidies for one natural resource and not for others, like iron ore, steel, and agriculture, except to the degree that you clarified that.

And it will also be a nation of 50 Wyomings, according to your theory. Fifty Wyomings. Now Wyoming is a wonderful, wonderful part of the country. But the whole issue of deductibility sort of seems to be premised on the notion that it's wrong to have 12 high tax States in America—it's wrong to have 1 State that has more undocumented workers in its cities than there are people in the whole State of Wyoming. I'm talking about New York City. And I imagine if I had the figures for Los Angeles I would find that same problem.

We are, I hope, one nation and not 50 competing States in which the lowest common denominator from the Federal standpoint has to be the lowest tax burden by State.

So let me stop at that point. Are you aware of the fact that the average income for all of those itemizers is only $32,000 a year? Or of the fact that those one-third itemizers actually pay about 45 percent of all the State and local taxes? Can that come out on the presentation on deductibility?

Secretary **Baker**. Those issues will probably come out.

Senator **Durenberger**. Or that per capita taxes in central city areas in this country are 37 percent higher than the suburbs. Could that sort of thing come out so that we can get a notion of where people are going to vote with their feet? Is that legitimate debate as far as——

Secretary **Baker**. Absolutely; without agreeing with those numbers, Senator, it absolutely is, yes, sir.

Senator **Durenberger**. Or that the number of States have the substantial ability to export their taxes to other states. I didn't want to comment on that—Texas and Montana, heavy tourist States, other States. Shouldn't that be part of the debate on fairness and deductibility?

Secretary **Baker**. I would question the latter assertion, Senator, but if you want to make it part of it, it's going to be part of it, so we will have a debate on it.

Senator **Durenberger**. Thank you.

The **Chairman**. Senator Armstrong and then Senator Mitchell.

Senator **Armstrong**. Mr. Secretary, I want to join my colleagues in congratulating you on your statement. And more than that, I would like to congratulate you on the process by which you brought this bill forward. I can't recall anything comparable to it in the years I have been around here, and I think it's a fine accomplishment.

I have two or three questions I would like to ask. First, mostly just for curiosity state, I note that there are a number of items in the package which have de minimis revenue implications. Really a long list of what would seem to be fairly controversial proposals for which there is just an asterisk in the table. What was the thought process that led you to include a number of those items?

Secretary **Baker**. I think the answer to that, Senator Armstrong, is that we felt that those were probably good policy. We didn't look at everything here with reference strictly to its revenue impact.

We did, on the other hand, try and recognize that certain things had some very high, if you will, political content, and were very controversial. And we eliminated those. Such things as taxing parsonage allowances, taxing veterans disability benefits, and the like where there was not a lot of revenue involved. So we have eliminated a lot of those things and the ones we have left, we have left on the basis that we think it's good policy.

Senator **Armstrong**. Could I ask you to address for a moment specifically the question of taxation of inside build-up of insurance? It seems to me that that sort of fits the description that you have just outlined. A lot of political content, little or no revenue implication as you have drafted the proposal.

Because what will happen is that people in the insurance industry will simply adjust their behavior so that they won't incur the tax. In fact, some of our friends in that business claim that they just think the life insurance business is over and are retraining to go into other kinds of work.

In your judgment, is it good policy to do that even though it doesn't raise any money or is that one you could specifically focus on?

Secretary **Baker**. Well, it won't raise any money in the first 5 years because we have grandfathered in all existing policies unlike what the original proposal did, after visiting with representatives from the life insurance industry.

I would like to say, Senator Armstrong, that we have received predictions such as that from a lot of people who are interested in a particular preference or particular exemption or deduction to the effect generally that this is going to mean the end of our industry or it's going to mean the end of Western civilization as we know it, and we simply don't think that's true.

The life insurance industry has been very adaptable in the past, and we think they are too innovative to be subverted by this proposal. All we are really asking is that all savings devices be taxed in the same way.

Senator **Armstrong**. If I indicated that I thought it was as catastrophic as that, I didn't really mean to.

Secretary **Baker**. No, you didn't. I just wanted to make the point, because we do receive those kinds of complaints all the time.

Senator **Armstrong**. Well, I'm sure, but I think what the more thoughtful people in that industry would say is that simply they will come up with different kinds of policies that don't have this feature. And so the revenue effect will be zero, if they are right, or it will be very small according to the projections that have been asterisked for the next 5 years and I think $200 million after that.

The same is true in the taxation of fringe benefits of airline employees and others on their travel. Now that isn't addressed in this bill, but we have just put it through, much to the dissatisfaction of people in that industry who traditionally have certain travel privileges that they have been denied. And the effect of it, according to the estimate, is negligible revenue. But really a hot controversy.

I would like to ask if you could comment briefly on an aspect of this bill which has to do with the deductibility in corporate income tax of those payments on dividends. There is a general recognition, I think, that our Tax Code in its present form greatly encourages the use of debt financing rather than equity financing with a couple of very concrete results, maybe more—but one of them certainly is. That this waive of takeover trouble a lot of people. That they have been greatly encouraged. I think a lot of economists and business people think that is at least enhanced and maybe actually caused by the fact that you can deduct the cost of borrowed capital; you cannot deduct the cost of equity capital.

So it has encouraged takeover. And, second, it has encouraged a lot of companies to become very, very highly leveraged. And in the opinion of some people, makes them vulnerable to adverse business circumstances; maybe even raises the possibility of a large number of prominent business failures because they are so highly leveraged. Some of them just incredibly leveraged.

My question, Mr. Chairman, I guess, is not within the 5 minutes. Maybe I could sum it up and the Secretary could answer it nonetheless.

Has the administration looked at this issue? And down the line would the administration be sympathetic to going further in making corporate dividends deductible?

Secretary **Baker**. We absolutely would, Senator, and I think my statement makes that clear when I say that for now this is at least a start toward eliminating the double taxation of dividends.

Senator **Armstrong**. Thank you, Mr. Chairman.

The **Chairman**. Senator Mitchell and then Senator Matsunaga.

Senator **Mitchell**. Thank you.

Mr. Secretary, as the other Senators do, I commend you for your presentation this morning. I would first like to ask: In the President's plan it is proposed that the deduction for property taxes be eliminated or repealed. That is, as you know, the principal means of support for public education in our society. It is inconceivable that the administration could propose this while still proposing tuition tax credits for parents whose children attend private school. May we, therefore, have a clear statement from you that the President no longer supports tuition tax credits for private education?

Secretary **Baker**. Senator Mitchell, if this bill is enacted in its current form, I think you might very well see that result. But tuition tax credits has been pending up here for a number of—well, for several years. And it's the President's view that we ought not to consider abandoning that until we know we are going to see this reform proposal enacted into law.

The **Chairman**. Excuse me. Could I hear that answer again? That if this bill is enacted, the President is going to abandon——

Secretary **Baker**. No, I didn't say that. I said we would at that point consider it, Mr. Chairman. I'm not suggesting that we would abandon it. But it's premature, certainly, to ask us to abandon it now simply because there is a proposal in here to eliminate the deduction for the State and local——

Senator **Mitchell**. Well, on the other hand, Mr. Secretary, it may make a difference on how people vote on repealing the property tax deduction as to what you propose to do with tuition tax credits. If what you are saying is that you want Congress to repeal the property tax deduction, which supports public school, while you reserve the right to come back in here after tax reform is passed and ask for tuition tax credits, that's an important factor to know before we vote on that plan.

Secretary **Baker**. I understand.

Senator **Mitchell**. So you won't say the President is opposed to it?

Secretary **Baker**. Well, I'm just saying I'm not prepared to say today. I certainly can't do that today. Now if it would appear that there was a significant number of people who felt that way, then I would have to take that issue to the President and he would have to make a decision one way or the other—which do you want?

Senator **Mitchell**. Well, I guess one isn't significant, but I want you to know it's a matter of concern to me.

Secretary **Baker**. I can well understand that, but it's a question of at what point do we consider that issue.

Senator **Mitchell**. Right.

Now to his credit and to your credit, the President has proposed to increase the tax threshold to an amount above the poverty threshold. This would be accomplished in part by increasing the personal exemption to $2,000, as is shown on the chart over here against the wall. It is, as you know, a very expensive way of providing tax relief. Approximately $5 billion in revenue is lost for each $100 increase in the personal exemption. Many analysts believe a more preferable and targeted approach to providing relief to low- and middle-income tax individuals would be to increase the standard deduction by a much greater amount than you have proposed, tieing it to family size, and increasing the personal exemption by a lesser amount. This would to a much greater extent target the relief in this plan to the middle class, and at a smaller revenue cost.

Was this approach—that is, increasing the standard deduction, tieing it to family size and increasing the personal exemption by a lesser amount considered, by the Treasury Department?

Secretary **Baker**. No, it was not. It was not considered in the preparation of Treasury 2. The President feels fairly strongly, I think it's fair to say, about the doubling of the personal exemption.

Senator **Mitchell**. Well, as you know, the benefit for that increases as one's income increases.

Secretary **Baker**. I understand.

Senator **Mitchell**. And that is one of the reasons why the reductions at the upper level are as high as they are.

On that point, the chairman raised a question earlier about conflicting statements. And Mr. Pearlman said he didn't know where the analysts got their information. The fact is that the information on the reduction of taxes for taxpayers earning $200,000 or more in economic income comes from a Treasury chart, which was not included in the statement that you presented today. It's an earlier Treasury chart, Mr. Chairman, which breaks down tax savings in more precise brackets than this one does. And it shows that according to the Treasury Department for those earning $200,000 or more a year, the reduction is 10.7 percent.

Secretary **Baker**. I believe that chart is included in the full book.

Senator **Mitchell**. In the full book.

Secretary **Baker**. Yes, sir.

Senator MITCHELL. But not in the presentation. The chart you included in the presentation today is actually a condensation of that.

Secretary BAKER. Yes, sir, it does speak in terms of economic income.

Senator MITCHELL. That's right.

The CHAIRMAN. Senator Matsunaga is the last questioner on our first round. When he is done, I'm going to give the Secretary about a 5 minute break and then we will just take a recess for that 5 minutes and then start on our second round.

Senator Matsunaga.

Senator MATSUNAGA. Thank you, Mr. Chairman.

The CHAIRMAN. Pardon me; I see Senator Pryor is back and he is also on the first round. It will be after Senator Pryor.

Senator MATSUNAGA. For whatever it is worth, Mr. Secretary, I wish to commend you for your manner of performance here. I've seen quite a number of Cabinet members testify before committees and your first appearance here has been very commendable.

Secretary BAKER. Thank you, sir.

Senator MATSUNAGA. I'm pleased to note that in your prepared statement you lay out six principles upon which your tax simplification proposal is based. The first of these you cite low tax rates to reward invention and innovation. And you also state that tax rates can be obtained only if the taxable income base is broadened.

The President, I suppose, in line with this basic principle, stated just last Friday, and I quote:

> I don't believe we want to increase our energy dependence on foreign imports or give the ailing OPEC cartel a shot in the arm. We must secure reliable, secure energy resources here at home.

Now in light of this call for energy independence, it appears to me that the administration's and your decision, I suppose, to terminate the renewable energy tax credits to be contrary to the stated aims both in your prepared statement and by the President in this statement made only last Friday. Could you comment on that?

Secretary BAKER. Senator Matsunaga, we believe that the energy tax credits were first enacted when price controls were in effect and when there was no incentive to conserve or use alternate forms of energy, and we wanted to present such an incentive.

That's no longer the case. We don't have price controls. And it seems to us that the market is better equipped to determine the use of conservation measures and alternate energy sources.

Let me, if I might, take 1 minute to read you a letter that was addressed, a copy of which was sent to me that arrived just yesterday, a letter sent to the chairman of the House Ways and Means Committee.

It says:

> Dear Dan: Enclosed is a copy of a newspaper advertisement from the Los Angeles Times for the windmill tax subsidy, which is a rip-off under existing Federal and State law.

Senator MATSUNAGA. Excuse me. Would you please get closer to the mike?

Secretary BAKER. Yes, sir.

> Which is a rip-off under existing Federal and State law. The windmill farms produce very little electrical energy, and when they do, the power company has to

pay the highest possible price under State law. The newspaper advertisement would lead you to believe all the 2,000 windmills on the highway between Palm Springs and Riverside, California are fully operational at all times. I've observed them on many occasions. Never more than 25 percent are operating even in the heaviest winds. Let me assure you 2,000 windmills desecrate the environment much more so than several oil rigs. I understand Secretary Baker's proposal terminates the Federal tax shelter for windmills. I hope Congress will agree.

Warmest best wishes, Gerald R. Ford.

[Laughter.]

Secretary **Baker**. And let me show you the advertisement, if I might, Senator, that he has included in his letter to the chairman of the Ways and Means. I just happened to get this yesterday. It says here:

> Convert your tax obligation to an income-generating asset. These are the facts. Tax benefits merely pay for your investment in a Zon Wind Turbine. Federal energy tax credits, 15 percent; Federal investment tax credits, 10 percent; California solar tax credits, 25 percent; Federal depreciation savings, 44 percent; California depreciation savings, 8 percent.

It's this kind of thing that we are seeking to eliminate.

Senator **Matsunaga**. Well, that, of course, is a very small percentage of the total program for development of renewable energy resources, resources especially which are indigenous to our country. In my State of Hawaii, for example, which at one time was 100 percent dependent upon imported oil, we have begun to develop the ocean, the OTEK Program, the biomass program, because trees will grow well in Hawaii.

Secretary **Baker**. I took a lot of his time, Mr. Chairman, for which I apologize.

The **Chairman**. Finish up this question first.

Senator **Matsunaga**. I didn't make an opening statement. [Laughter.]

But I would think that because of the incentives which were provided to businessmen who otherwise would not have gone into the development of alternative sources today are 20 percent of our energy. Electricities produce some indigenous resources. And it was on a rapid increase until this threat of doing away with the energy tax credit that came about in his first budget. President Reagan proposed the elimination of the energy tax credit. And we had an 80 megawatt wind farm planned for Hawaii and the investors withdrew. And that would have added considerably to eliminating imports of foreign oil.

You must remember that one of the things, if not the major thing, which causes our deficit in balance of trade is the exorbitant amount of oil which we import from foreign countries. And I think you are going against your principle, basic principle, and making a big mistake in not continuing energy tax credit for the development of alternative energy resources.

I have exceeded my time, Mr. Chairman. I yield.

The **Chairman**. Senator Pryor, and then we will take a very short 5-minute recess.

Senator **Pryor**. Mr. Chairman, I don't think I will take all of my 5 minutes. I will try not to. I just have two or three questions.

One, I'm very proud to see that former President Ford is tilting at windmills and I think——

[Laughter.]

Senator **Pryor**. And we should assist him in that endeavor.

First, Mr. Chairman, I have a short statement I would like inserted in the record.

Second, and I would just like to ask this question as it related—as it relates to the individual versus corporate share or the ratio that you intend to have resulting from the President's tax proposal—individual versus corporation taxes. For example, in 1950, the individual income tax share as percentage of total receipts was in the neighborhood of 40 percent where the corporations were paying about 26½ percent.

Today, that has shifted dramatically. We now see the individual, as of 1983, paying 48 percent, the corporation down to 6.2 percent. And my question: In the President's proposal, what would you purport to be a fair and actually the resulting figure of the corporate share versus the individual share of total receipts?

Secretary **Baker**. Could I state it as a percentage of GNP? Would that be satisfactory?

Senator **Pryor**. I think that would be right. I don't know whether this table I have, prepared by the Joint Committee on Taxation—I guess that would be a GNP figure. But if that's all the figures you have, let's see.

Secretary **Baker**. Well, if I could submit the percentage of receipts figures for you for the record, I would like to do so, Senator Pryor, and say that on the question of the percentage as a percentage of GNP, it seems to me that 2.5 percent for the corporate share as a percentage of GNP would be an appropriate figure.

[The information from Secretary Baker follows:]

INDIVIDUAL INCOME TAX AND CORPORATION INCOME TAX RECEIPTS: AMOUNTS AND AMOUNTS AS SHARES OF TOTAL RECEIPTS AND GNP; FOR SELECTED YEARS, 1940–90

[Figures for fiscal years 1985–90 are consistent with the President's budget for 1986, released February 1985, and with the President's tax reform proposals to the Congress, as released May 1985]

Fiscal year	Individual income tax receipts			Corporation income tax receipts		
	Amount (in billions)	Amount as percent of		Amount (in billions)	Amount as percent of	
		Total receipts	GNP		Total receipts	GNP
1940	$0.9	13.6	0.9	$1.2	18.3	1.3
1945	18.4	40.7	8.5	16.0	35.4	7.4
1950	15.8	39.9	5.9	10.4	26.5	3.9
1955	28.7	43.9	7.6	17.9	27.3	4.7
1960	40.7	44.0	8.2	21.5	23.2	4.3
1961	41.3	43.8	8.1	21.0	22.2	4.1
1962	45.6	45.7	8.3	20.5	20.6	3.7
1963	47.6	44.7	8.2	21.6	20.3	3.7
1964	48.7	43.2	7.9	23.5	20.9	3.8
1965	48.8	41.8	7.4	25.5	21.8	3.9
1966	55.4	42.4	7.7	30.1	23.0	4.2
1967	61.5	41.3	7.9	34.0	22.8	4.4
1968	68.7	44.9	8.3	28.7	18.7	3.4
1969	87.2	46.7	9.6	36.7	19.6	4.0
1970	90.4	46.9	9.3	32.8	17.0	3.4
1971	86.2	46.1	8.4	26.8	14.3	2.6
1972	94.7	45.7	8.4	32.2	15.5	2.8
1973	103.2	44.7	8.2	36.2	15.7	2.9
1974	119.0	45.2	8.6	38.6	14.7	2.8
1975	122.4	43.9	8.3	40.6	14.6	2.7
1976	131.6	44.2	8.0	41.4	13.9	2.5

INDIVIDUAL INCOME TAX AND CORPORATION INCOME TAX RECEIPTS: AMOUNTS AND AMOUNTS AS SHARES OF TOTAL RECEIPTS AND GNP; FOR SELECTED YEARS, 1940–90—Continued

[Figures for fiscal years 1985–90 are consistent with the President's budget for 1986, released February 1985, and with the President's tax reform proposals to the Congress, as released May 1985]

Fiscal year	Individual income tax receipts			Corporation income tax receipts		
	Amount (in billions)	Amount as percent of		Amount (in billions)	Amount as percent of	
		Total receipts	GNP		Total receipts	GNP
1977	157.6	44.3	8.5	54.9	15.4	2.9
1978	181.0	45.3	8.7	60.0	15.0	2.9
1979	217.8	47.0	9.2	65.7	14.2	2.8
1980	244.1	47.2	9.5	64.6	12.5	2.5
1981	285.9	47.7	9.9	61.1	10.2	2.1
1982	297.7	48.2	9.8	49.2	8.0	1.6
1983	288.9	48.1	9.0	37.0	6.2	1.1
1984	296.2	44.4	8.3	56.9	8.5	1.6
1985	329.7	44.7	8.5	66.4	9.0	1.7
1986	341.0	42.9	11.8	93.0	11.7	3.2
1987	366.5	42.5	12.0	113.5	13.2	3.7
1988	401.6	42.6	12.5	123.2	13.1	3.8
1989	446.5	43.5	12.5	130.6	12.7	3.6
1990	485.7	43.9	12.6	137.8	12.5	3.6

Source: Office of the Secretary of the Treasury and Office of Tax Policy, May 29, 1985.

Secretary **Baker**. As I have indicated earlier, we have gone from a period in 1960 where the corporate percentage was about 4½ percent of GNP down to the point today that it's about 1.6. Our bill takes it back up to 2.48. So 2.5 would be the figure that I would cite for you for the corporate share.

And I will have to supply you with the individual share expressed as a percentage of GNP.

Let me just say this. The 25 year average for corporations is 3.64 percent of GNP. You know, there was a lot of debate originally when this proposal surfaced that there was a massive shift here—putting the burden on the corporate sector to benefit individuals. And I suppose these figures would belie that.

Senator **Pryor**. Mr. Secretary, I appreciate your attempt to answer that, but I think the table that I have is only as a percent of total receipts, which is the 6.2 figure, 48 percent by individuals. And if possible, for the record, if we could use the same total receipt posture. If we could do that, I think that would be most helpful.

Secretary **Baker**. We will get those for you, Senator.

Senator **Pryor**. Fine.

And, also, Mr. Secretary, I'm wondering if you have had your staff analyze how much revenue will be raised each year by the tax on employer paid health insurance premiums. Has there been an analysis of the income figure there?

Secretary **Baker**. Yes, sir, just 1 minute; it's in the revenue tables here.

[Pause.]

Secretary **Baker**. In 1986, Senator Pryor, it's $2.4 billion; in 1987, it's $3.5 billion; in 1988, it's $3.7 billion. That's all found on page 453.

Senator **Pryor**. Good, thank you very much.

And my final question—I see the yellow light on: What would be the revenue estimates from the accelerated repeal of the charitable deductions for nonitemizers? Do you have that figure also in or around that same page number?

Secretary **Baker**. We can dig it up for you.

[Pause.]

Secretary **Baker**. Of course, that's supposed to expire in 1987, Senator Pryor, so the figure is $400 million for 1986 and $2.7 billion for 1987.

Senator **Pryor**. Mr. Secretary, let me just add once again my salute and congratulations for your demeanor and for your appearance here today. And we look forward to working with you.

Secretary **Baker**. Thank you, Senator.

Senator **Pryor**. Thank you, sir.

The **Chairman**. We will take a 5-minute recess and then continue on until we are done.

[Whereupon, at 11:50 a.m., the hearing was recessed.]

AFTER RECESS

The **Chairman**. The committee will come to order. We will start off again on a second round. Senator Grassley is not here right now. He did not get to ask questions on the first round, and I told him I would insert him in the second round when he returned. But until he gets here, we will start off with Senator Moynihan, followed by Senator Chafee, and then I think I'm next.

Senator Moynihan.

Senator **Moynihan**. Thank you, Mr. Chairman.

Mr. Secretary, we are going to go through a long period of analysis and effort to fix these moving parts. I mean we have a tax proposal here with about 800 moving parts. There is no way around that. And assessing what happens when you take one out, put another one in, whatever, is going to be a real effort. And I know that this committee would very much hope it can be a cooperative one.

There's a rule that everybody is entitled to their own opinion, but not to their own facts. And to the degree that we can share with the Treasury some general assessment of the likely effects on revenues of this particular change, knowing these are approximations, it will make a big difference in working together as we hope to do. And you have been very candid about this so far.

But I noticed earlier you said, for example, there are now corporations and individuals paying negative tax rates. Which is to say the Government pays them as a result of what we did in 1981. Well, we might have anticipated some of those things had we looked more closely.

It behooves us to try to anticipate some of the likely results of this proposal as well. For example, there is something in the economic literature—tax price theory—that allows us to estimate the impact of eliminating State and local tax deductibility.

This theory can be demonstrated rather simply. Let us assume that taxpayers can spend their last dollars of income in one of two ways. They can keep 72 cents and pay 28 cents—the average marginal tax rate—to the Federal Government. Or they can give the entire dollar to their local governments to spend on public services—building roads or educating children.

Economic theory tells us that these taxpayers are really getting 1 dollars' worth of public services for only 72 cents. In the jargon of economics, the "tax price" of $1 of local services is 72 cents.

Now, if State and local tax deductibility is eliminated, the tax priced of $1 of local services will rise from 72 cents to $1, a 40-percent increase. According to the Congressional Research Service, taxpayers are likely to insist that about half this tax increase—and the services they support—be rolled back. Since repeal of the deductibility would increase the real local tax burden by 40 percent, if voters accepted only half this addition, spending for local services would decline by 20 percent.

May I ask CRS if we might send you these and ask for your comments?

Secretary BAKER. Sure, yes sir, Senator.

Senator MOYNIHAN. Just as you are going to send us some.

Secretary BAKER. Absolutely.

Senator MOYNIHAN. And send us the Social Security estimates. And I hope that doesn't take too long. You have got the actuaries to do it for you.

[The information from Secretary Baker follows:]

The Congressional Research Service study to which Senator Moynihan refers is the October 1983 study by Nonna A. Noto and Dennis Zimmerman entitled "Limiting State-Local Tax Deductibility in Exchange for Increased General Revenue Sharing". Dennis Zimmerman provided an update on this study in a May 22, 1985 memo to the Joint Economic Committee which presents substantially different estimates of the effect on state and local spending of eliminating state and local tax deductibility.

The 1983 study implied that eliminating tax deductibility could decrease state and local spending by as much as 20.5%. The most important change in the 1985 study is the explicit recognition that "the dollar value of nonbusiness State-local taxes deducted by individuals on their Federal tax returns represents less than 15 percent of the revenue spent by State-local governments in fiscal year 1980." Largely due to the inclusion of this factor, the updated estimate is that without tax deductibility, State-local general revenues would decrease by about 1.5%. This makes tax deductibility not only a very costly form of implicit aid to state and local governments, but a very inefficient one. For every dollar of Federal revenue foregone, state and local governments gain less than fifty cents.

We agree with the basics of the new Congressional Research Service methodology and with the 1985 estimate. The question of the effect of tax deductibility in reducing the tax price of state and local services and its further effect on the level of state and local spending has only been addressed in a concentrated way by public finance economists in the last two years. For that reason, there are a number of unanswered questions such as: what the role of itemizers versus nonitemizers in state and local government decisionmaking is, to what extent itemizers perceive the price reduction arising from tax deductibility, and whether price elasticities of demand for state and local services from the larger public finance literature should appropriately be applied to this problem. However, given the current state of the literature, the CRS study as modified by the 1985 memo provides a reasonable estimate of the aggregate effect on state and local spending of removing federal tax deductibility.

It is not possible to furnish the information requested, viz., alternative estimates of receipt impacts of the President's tax reform proposals based on the three different projections of GNP used by Social Security Administration actuaries in preparing the Trustees' Report.

This is because the high, low, and middle-range GNP projections are not complete macroeconomic forecasts of the national income accounts and related information. While the underlying income projections may be adequate for predicting alternative Social Security Trust Fund balances, they are not a sufficient basis for estimating tax receipts.

Senator **Moynihan**. Now in the spirit of this thing, friendly, cooperative, can I say to you that over the weekend it was a bit of a disappointment to have the President's director of communications, Pat Buchanan, describe the 15 "high tax States" as neosocialists. I don't know what neosocialist means. I don't expect you do. I'm not going to ask you to tell me unless you wish to. But, you know those 15 States contain 41 percent of the American population.

Could I ask you candidly: Do you think it was helpful to have us described as neosocialists because we pay our share of Medicaid costs and look after a couple of million undocumented aliens who got through a non-Socialist government customs service?

Secretary **Baker**. It would appear, Senator, from your reaction that it was not. But I'm glad you didn't ask me the question you said you weren't going to ask me. [Laughter.]

Senator **Moynihan**. I didn't ask you what it meant. But I do ask you if you think it was helpful to have said it.

Secretary **Baker**. I've just said, judging from your reaction, it would appear not.

Senator **Moynihan**. That's fair enough. And perhaps we could look forward to a debate in which we don't throw words at each other like that in the future, because we are capable of being, you know, gentle and genial about this. We are also capable of getting pretty mad.

Secretary **Baker**. Yes, sir, I understand that. And I have said all along, Senator, and I would repeat—and I think I said in my statement here this morning—that we are not going to have tax reform unless we have it on a bipartisan basis.

Senator **Moynihan**. Right.

Thank you.

The **Chairman**. Senator Chafee.

Senator **Chafee**. Mr. Secretary, pursuing the subject of State and local taxes, which you have dealt a lot of time with today, is there any theory that you might have access to or material that would indicate that by having the taxes nondeductible, as you propose, that it might increase the attention of these higher taxpayers to the condition of the local schools and thus overall be a beneficial step? In other words, the people from these higher tax brackets who previously might have had little interest in local government, because the Federal Government is paying half their share anyway, now will their attention be focused on local government to the benefit of local government?

Secretary **Baker**. We think that's entirely possible, Senator Chafee. We have not gone out and done a study or tried to pull together data to prove that that state of mind would indeed occur. But it seems reasonable to us to assume that it would.

Senator **Chafee**. The only reason I ask for any data you might have is because obviously all the witnesses that we will have in here will be telling us how awful this provision is, and suggesting that this is attacking those who fulfill their social obligations.

Secretary **Baker**. Well, may I just volunteer there, if I might, Senator Chafee, that I would certainly disagree with that conclusion. And, quite frankly, as we have pointed out before, even if you just look in the States themselves that are the so-called high tax States, of which, indeed, I see your State is one, it's the poor Joe who doesn't itemize that is carrying the load. It's the two-thirds of taxpayers that don't itemize who are in effect picking up that subsidy. That's why we say on fairness it's not unfair for us to suggest that there should be an elimination of the State and local tax deduction.

Senator **CHAFEE**. Well, at this point——

Secretary **BAKER**. Don't even get into the debate between the States, is what I'm saying.

Senator **CHAFEE**. Well, at this point you are preaching to the choir because as of now I think your proposal is good in that area, but my Governor doesn't agree with me.

Let me take up another point. You have the phasing out of some tax credits.One of the tax credits that particularly in our area of the country has clearly worked is the historic preservation tax credit, the rehabilitation tax credit. You can clearly see its cause and effect in Rhode Island.

The **CHAIRMAN**. You mean both of them?

Senator **CHAFEE**. No; just the historic preservation. I wonder if you have given any thought to the suggestion of phasing that out. I've seen its effect not just in my area. I've seen it in the city of Baltimore and, indeed, many other sections of the country.

Senator **MOYNIHAN**. All across New York State.

Senator **CHAFEE**. All across the United States. I think we can clearly say that but for the presence of those historic preservation tax credits, the rehabilitation of these buildings, railroad stations, whatever they might be, would not have taken place.

Secretary **BAKER**. I don't argue with that, Senator Chafee. But I would say if you are going to have tax reform—I mean I think you can advance very persuasive arguments for all of these tax credits, particularly for them at the time they were originally put into the system. But if you are going to broaden the base, and you are going to bring rates down for everybody, including corporations, you simply cannot maintain all of the various credits. And as my statement indicated, we are really calling only for the retention of the foreign tax credit, which is a double taxation situation, and the R&D tax credit, because we think this proposal—we agree with many of you when you say this must be a pro-growth proposal.

Senator **CHAFEE**. Well, what I'm talking about is the phasing out of this credit. In other words, you phase out the precentage depletion, did it occur to you to phase out the historic preservation tax credit?

Secretary **BAKER**. I, again, can't answer with respect to Treasury 1.

Senator **CHAFEE**. No; I'm talking about Treasury 2.

Secretary **BAKER**. No, sir, not for Treasury 2. We did investment tax credit the same way. All of them.

Senator **CHAFEE**. I know what happened. I'm just wondering if——

Secretary **BAKER**. No, sir, we did not.

Senator **CHAFEE**. Was there debate on whether to phase them out?

Secretary **BAKER**. No, sir.

Senator **CHAFEE**. Thank you.

Thank you, Mr. Chairman.

The **Chairman**. Senator Grassley.

Senator **Grassley**. You are seeking equity and fairness in the taxation of employee fringe benefits. Was consideration given to the after-tax cost of health insurance for self-employed individuals?

Secretary **Baker**. Yes, sir, I think it was. The answer to that is "Yes," unqualified yes.

Senator **Grassley**. And it was rejected as—when you were working out the compromise on health insurance, you were going to have $10 for the individual and $25 for the family.

Secretary **Baker**. Yes, sir.

Senator **Grassley**. It was still tolerant to go along with that exemption and still not offer the same thing to self-employed individuals. In other words, the farmer who is in a corporation tax situation where he has the deductibility of that versus the self-employed individual who does not have that deductibility.

The **Chairman**. There's a double irony in that. Chuck, you can be self-employed and you are employing three or four people and you can provide health insurance for your employees and deduct it. You cannot include yourself in it. But if you were incorporated, you could.

Senator **Grassley**. OK, so why not include as a matter of fairness for the self-employed individual as well as for the employees?

Secretary **Baker**. Well, I think conceptually, Senator, we don't disagree with that. But that's a revenue problem. There is a serious revenue problem created by that approach. And that's not, again, something that was proposed in the original proposal.

Senator **Grassley**. Well, OK, I accept the Secretary's reason for it. I, of course, don't agree with it. And I would suggest to the members of the committee that this is something that probably, if we are going to come—with tax reform that is going to be probably long-lasting and as encompassing as this is, that that's something that we are going to have to deal with and from that standpoint I ask the administration to deal with that as well.

Secretary **Baker**. Senator, if I might say. What we have done—you know, we recognize the disparity. I think what we have done narrows the disparity. It doesn't widen it.

Senator **Grassley**. True; I do see that movement in that direction, but I guess I feel that there is an inequity there. That you have people in almost like situations being treated differently. And one of the goals of this program is to treat taxpayers in like situations the same way.

Secretary **Baker**. If I might add to that, Senator. That's one reason in our original proposal we had called for more extensive taxation of fringe benefits generally.

Senator **Grassley**. We are all aware of the recent problems that the IRS service centers had with programming the new computer system and processing tax returns. Assuming Congress can pass a tax bill and President Reagan signs it so that by January 1, 1986, it's institutionalized, can IRS revise its forms, reprogram its computers, and issue the necessary guidance to taxpayers required to implement the system by the proposed effective date?

Secretary **Baker**. Yes, sir, Senator Grassley. Senator Dole asked me that this morning and my answer to him was if we can get a bill signed by the President in December, I think we can implement an effective date of January 1, provided it's not too late in December.

Senator **Grassley**. Provisions of the proposal broadening the tax base are to become effective January 1, 1986, with the lower marginal rates effective in July. Has the Treasury estimated what impact this lag will have on the tax liabilities of individual taxpayers for the 1986 tax year?

Secretary **Baker**. We don't think it will have a significant adverse impact, Senator. In any event, it's a one-time situation. And the reason we don't think it will have a significant adverse impact is because we are doubling the personal exemption immediately as well as increasing, as you know, the zero bracket amount and the earned income credit. So we don't think that there is going to be a significant adverse impact on individuals as a result.

Senator **Grassley**. Has the Treasury estimated the effect that base broadening will have on Social Security tax liabilities? My concern is with the individual earning less than the base amount will find that their Social Security taxes are increased while their marginal tax base on their income has correspondingly decreased.

Secretary **Baker**. Well, I think that's true. They will find that. I'm not sure I understand your question.

Senator **Grassley**. Well, the question is as we are asking people to consider this, are they going to be paying higher taxes in Social Security than they are going to benefit from in the—from the effect of the offsetting income tax rate.

Secretary **Baker**. Have we run a comparison of what this will do to individuals in terms of reductions against what the already legislated Social Security tax increases will mean?

Senator **Grassley**. Yes.

Secretary **Baker**. No, sir; but we will be glad to.

Senator **Grassley**. Well, and particularly because of—it broadens the——

Secretary **Baker**. We assume that there would be an adjustment in the Social Security rates so there wouldn't be a double burden, if that's the thrust of your question.

Senator **Grassley**. Well, that's——

Secretary **Baker**. We will certainly take a look at that, Senator.

Senator **Grassley**. We should pursue that further because I think there are some unintended impact there.

The **Chairman**. Mr. Secretary, the strongest—not the strongest, but certainly a strong opposition to this bill comes from those who are currently maybe in the high income bracket, maybe not, but they are using deductions and credits and we are going to take them away from them.

Over the past 2 months, I have asked randomly almost everyone I can run across how low would you have to get the maximum rate before deductions became irrelevant, before they would no longer be a factor in your thinking. And this is really subjective. The Senator from New Jersey was asking about objectivity and capital gains. I have no study. Do you have any intuitive idea or any study as to how low the maximum rate would have to be before the bulk of the people who now are concerned about deductions would not pay much attention one way or the other in their actions?

Secretary **Baker**. As individuals?

The **CHAIRMAN**. Yes, individuals.

Secretary **BAKER**. We have no study, Mr. Chairman. I suppose that when you get down to the 20-percent range, you have pretty well negated the benefit of any deductions. I think getting there is the problem. We tried very hard to get to 30. We found ourselves facing distributional problems and that's why we stayed with 35.

The **CHAIRMAN**. It's almost ironic. If you could get to a maximum rate of 30 or maybe 25, then I think in a subsequent year I think you would have less difficulty getting rid of many more deductions because you would have gotten over the hurdle of many people caring one way or the other, and it's almost the dog chasing his tail. We can't get the 25 or 30 and therefore people are still concerned with State and local taxes or whatever else it is because of the deductions.

Secretary **BAKER**. That's right. I tend to agree with you, Mr. Chairman, but I would point out that under this proposal we do reduce the top rate to 25 percent or less for 97 percent of the Nation's taxpayers.

The **CHAIRMAN**. Let me ask you now another question on oil and gas and national security. And the reason for putting the tax preferences back in and you said it was basically national security.

Secretary **BAKER**. I would prefer to say the reason for suggesting that some of them be eliminated from current law.

The **CHAIRMAN**. Would be national security?

Secretary **BAKER**. No. The reason that we have suggested that some be eliminated rather than all was on national security.

The **CHAIRMAN**. All right. That's fair enough. Because I was going from Treasury 1 to Treasury 2. But you are right. In terms of the present law or the present bill, it is still eliminating some.

Did you give any thought—and I will preface this by saying that in the years I've had testimony in this committee, I have concluded this country is fortunate. We could be energy independent domestically if we wanted. If estimates are right—and estimates on natural resources are about like revenue estimates. But we apparently have a 400-year supply of coal, a 200-year supply of oil shale, a great amount of tar sands, unutilized hydro potential as yet—we could be energy independent if we wanted to follow the same policy that we have followed in military shipbuilding. We just said they have to be built in America. And if we didn't have that, my hunch is all of our military ships would be built in Korea or Poland or Japan or some place else. What if we were to adopt a policy in energy of eliminating all tax preferences and saying that all energy had to be produced in this country, and you decontrolled all energy? Why would not that achieve energy independence without having to use the Tax Code, and at the same time move us toward a very worthwhile goal?

Secretary **BAKER**. It might well do so, Mr. Chairman, at, I suppose, some cost in terms of what our unit of energy would cost us relative to what it cost us today.

The **CHAIRMAN**. No question, because you would then have to embargo imported low cost oil and you would have to reconsider your purchases from Canada and Mexico, and you would have to say we are going to move toward the goal of energy independence and whether that means that coal is cheaper in this country or gas is cheaper than both, I don't know, but they certainly would find their own level relatively quickly.

Secretary BAKER. And you would have to do significant things with respect to coal and oil shale, I think, to bring them into a productive capacity situation.

The CHAIRMAN. I'm not sure you would have to if you said you were going to produce all of your energy in this country. And if, indeed, we are running out of oil, and if, indeed, tar sands turns out to be more expensive than oil shale or they are both more expensive than oil, we would start moving toward the one that of the remaining resources was the most efficient to use.

Secretary BAKER. We would. What I meant was we would have to do so at some significant increase in capital cost.

The CHAIRMAN. Yes. And significant increase in the cost to the industry.

Secretary BAKER. And the bottom line cost, yes, sir.

The CHAIRMAN. Third question on transitional rules and fairness. Generically, what is fair, whether it's a 936 corporation in Puerto Rico or rather it's timber that somebody has bought thinking they could expense the cost of it carrying up to 40 years and then they find it changed? What touchstone should we follow in terms of transitional rules, assuming we are going to change, so that people who have made investments based upon the Tax Code don't suddenly find themselves in an unfair position?

Secretary BAKER. I think it's very difficult to quantify or define, Senator. I think you have to look at what has been done in the past, what has been done traditionally and historically. And I think it really depends upon the innate sense of fairness of a majority of the committee as to what is an appropriate transition rule in a particular case because there is tremendous potential for abuse. And, quite frankly, that's why we did not try to write the transition rules with respect to many of these proposals. We instead say that we think that's a matter properly left to the taxwriting committees of the Congress through consultation with us, and we want to work closely with you in that regard.

The CHAIRMAN. Senator Heinz and then Senator Bradley.

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Secretary, Senator Baucus, Senator Roth and others have kind of made the point that we are concerned about the net effect of these proposals on our manufacturing base, particularly vis-a-vis the foreign competition. And I know you are concerned about that, too, and I won't go into detail on whether or not your proposal, whether you mean it to be that or not, is really a blueprint for a service based economy. But I do worry when as I read, as I think you read on page 17 of your statement, that under the President's plan there should be a shift in the composition of investment toward more industrial and commercial structures and inventories. Producing, correspondingly, longer life of capital.

And, if you do not replace the equipment in the industrial structures, of course, the people who work these in structures tend—to be office workers and, therefore, tend to be in the service sector.

Leaving that aside, I am concerned about the recapture or windfall provision which by your estimates raises some $57 billion over 5 years on those manufacturing businesses principally, but not exclusively, that have taken advantage of ACRS and the investment tax credit. And which if statistics are to be believed, are still having a fairly rough time of surviving the strong dollar and other problems.

And what you proposed is to, in effect, go back and say we gave you these tax breaks in 1981 and you played according to the rules, but we are changing the rules for the future, and, therefore, we are going to retroactively change the rules for you there because you are going to benefit from a lower tax rate, on the assumption, I guess, that you are actually making money.

Now let's leave aside the question as to whether or not that is fair on top of all the other things that you appear to be doing to manufacturing and incentives for equipment. What I am concerned about is the principle involved here, which is that every time we would reduce effective tax rates that we have to go back and recapture revenue under old rules. That's really the principle here. And, frankly, if that's your principle, I don't understand why you have been inconsistent in applying it. One of the changes you are making is to include intangible drilling costs and the minimum tax. Why not retroactively go back and include intangible drilling costs in 1981, 1982, 1983 and all the way back to wherever? Because their intangible drilling costs are going to benefit in the future from lots lower tax rates on individual returns. Why pick on one area?

And, second why do this at all?

Secretary BAKER. Well, I hope I answered—tried to answer the question this morning about why one area. And the answer is that it was done in order to be able to liberalize considerably the depreciation rule, even from current law. And by the way, plants and factories would be structures. And while equipment may not be as——

Senator HEINZ. Only the exteriors; not the interiors.

Secretary BAKER. While equipment may not be as well off, Senator Heinz, as it is under current law, it is vastly better off than it would have been under Treasury 1.

I don't think that we are breaking our bargain with the people who went out and purchased equipment on the representation that if you do this you can take accelerated depreciation—because the deal, frankly, was this: If you do this, you can take accelerated depreciation on it, and postpone paying us tax on it at the rate of 46 percent for a period of time. And they said fine, and they went out and did it. And we have now come along and said or suggested that we reduce the top corporate rate from 46 to 33 percent. They will generally speaking, be no worse off than they are under current law. Absolutely no worse off. All new capital will be entitled to the new depreciation rule. And the only other way, quite frankly, Senator, to have done it would have been to try to and phase in some way the corporate rate reduction and combine that with some other measure to recoup revenue. So, I don't think it's breaching faith. And I really don't think it's an unfair proposal.

Senator HEINZ. Presumably, the principle here is because we've had a rate reduction what you are going back and recapturing—and I guess my time has expired and I will make this one brief comment.

You said back in February, as I recollect, that you wouldn't have any effective dates prior to the date of enactment of this legislation or prior to January 1, 1986. Chairman Packwood and Chairman Rostenkowski then went out and issued a statement endorsing that and then some. It seems to me that by going back here, you are flying in the face of both your own statement and of the statements by the chairman of the two tax-writing committees.

If that is true, we have a 50—and the chairmen stick by their guns—we have a $57 billion hole in the tax reform proposal.

The CHAIRMAN. That's close to revenue neutral though. [Laughter.]

Senator HEINZ. Depends, I guess, what the base is, Mr. Chairman, but that's right.

Secretary BAKER. Senator Heinz, I would like, at least in my own defense, to suggest that this does not violate any statement or pledge that I might have made with respect to the effective date of the bill overall.

Senator HEINZ. I expected you to stick by your guns.

The CHAIRMAN. Senator Bradley, and then Senator Durenberger.

Senator BRADLEY. Thank you, Mr. Chairman.

Mr. Secretary, you have outlined an argument in defense of the intangible, drilling-cost deduction based upon national security. At the same time, in response to Senator Matsunaga's question, you have said we certainly don't need to subsidize windmills. You said in response, I think, to Senator Symms we certainly don't need to subsidize energy sources like coal.

From a policy standpoint, why should we subsidize oil and not subsidize other forms of energy that would reduce our dependence on foreign sources of oil?

Secretary BAKER. Because we are so heavily dependent upon oil, Senator Bradley, and because that is a commodity that we might need and need in a hurry. The others are, for the most part, techniques or ideas really for developing alternative energy sources. And there is nothing wrong with those ideas, but quite frankly, they do not have the national security implications that exist with respect to oil and gas because we are so heavily dependent upon that and upon foreign imports of that.

Senator BRADLEY. Well, if I could, I'd like to offer a different point of view here. You said we would need it in a hurry. If we had a disruption in the supply of oil, the only thing that we would be able to get in a hurry is oil from the Strategic Petroleum Reserve.

Secretary BAKER. Correct.

Senator BRADLEY. And it's unfortunate that there will be no new oil put into the reserve as of last year—as of this coming year. So I don't think——

Secretary BAKER. I don't think that's——

Senator BRADLEY. I don't think it is a strong argument for energy security, and I would argue that it is a drain on America's first energy policy.

And I know you don't agree with that, but when those facts are combined with the distributional effects of the IDC, I think that it really merits a second look, although I am candid enough to admit it is unlikely it will get a second look in this committee. But I hope that you would examine it.

Let me make just one other point.

Secretary BAKER. Can I just say one thing on SPRO?

Senator BRADLEY. Yes.

Secretary BAKER. The Strategic Petroleum Reserve. We are not calling for an end to SPRO, the acquisition of oil for SPRO. We are suggesting that it be delayed for 3 years because we have made substantial progress in filling the reserves. And with the budgetary constraints that we now have on us, this is one area we think we can go a little slower.

Senator BRADLEY. It is true that as of next year there won't be oil going into the reserve.

Secretary BAKER. For next year, yes, sir.

Senator BRADLEY. That's right. And the year after that, and the year after that.

Secretary BAKER. For 3 years, assuming current policy remains. Only for 3 years. Then it will come back in.

Senator BRADLEY. Do you have a recommended rate at the end of 3 years?

Secretary BAKER. I'm not sure whether OMB's proposal on the budget had a recommended rate or not, Senator.

Senator BRADLEY. But do you have a personal rate?

Secretary BAKER. I do not, but we can certainly get you the information.

[The information from Secretary Baker follows:]

Although the Office of Management and Budget had exhibited the impact of the Administration's budget proposal for the next three fiscal years, an indefinite moratorium on adding to the Strategic Petroleum Reserve was proposed. However, as part of the proposal, a periodic evaluation of the oil market was also envisioned. If such careful examination of the world energy situation should suggest termination of the moratorium, the Administration would, of course, consider such change in policy. Until such time, however, no specific future "fill rate" has been suggested.

Senator BRADLEY. Let me also go back to the capital gains question. You have said a number of times in response to people's questions that you really wanted to get the top rate lower than 35 percent, but you had distributional problems.

If you cut the capital gains rate to 17½ percent and 75 percent of that benefit goes to people who earn more than $200,000, it should be a clue that part of your distributional problem is that you cut the capital gains rate too low. If you hadn't, you could possibly get the rate down close to 30 percent at the top level. And my question to you is do you believe that if the top tax rate were low enough, the differential would be relatively unimportant? Or do you believe that no matter how low the rate is, the differential is critical?

Secretary BAKER. I think, Senator, as I indicated to the Chairman, we have in our proposal that 97 percent of all taxpayers will enjoy a top rate no higher than 25 percent. Clearly, the lower you can get the top rate, the less important is the differential or any other preference or deduction.

I still believe, almost regardless of how low you get the rate for new ventures starting up, it is critical to sustain entrepreneurship in this country that the person willing to get out there and innovate and take a risk have some special reward.

Senator BRADLEY. No matter what the rate was?

Secretary **Baker**. Well, no, I wouldn't go that far. I mean if you can get that—a lot of people talk about a 10-percent flat rate. Clearly, there wouldn't be a differential suggested there.

Senator **Bradley**. Well, it is a question of belief.

Secretary **Baker**. Yes, sir.

May I also say one other thing? I don't think getting the capital gains rate down from 20 to 17½ percent significantly increased that little distributional problem that we are talking about.

Senator **Bradley**. We have had a lot of discussion about State and local tax deductions. Another method—in fact the major method—that state and local governments use to finance projects is through general obligation bonds, public purpose bonds. And under the President's proposal, those are retained.

If you had a major tax reform bill that eliminated a lot of the tax shelters, and a lot of the unnecessary investment or unproductive investment, do you think that State and local governments might be able to get a better deal in selling those bonds to the public? And could you describe that?

Secretary **Baker**. Well, I'm not sure whether I can describe it, Senator. But the answer is yes, I think they would get a better deal. It just seems to me that there would be less competition for those bucks. So they would get a better deal.

Senator **Bradley**. Thank you.

The **Chairman**. Senator Durenberger.

Senator **Durenberger**. I just want to say that after these 2 or 3 hours I am much more optimistic about tax reform than I was 3 hours ago. And that is a compliment to the Secretary of the Treasury. I haven't felt quite this optimistic since Drew Lewis was here in with the gas tax. And it is a compliment to you, Mr. Secretary, and your grasp of the issue and your sensitivity to where a lot of us would be coming from on that issue.

I'm not going to belabor the State and local tax deductibility because I have this long letter that does that which I will deliver to you.

But I just want to make a suggestion—listening to the exchange of George Mitchell and what he had to say about the issue—I would suggest to you that you move your argument off of unfairness to nonitemizers. Otherwise, we will come back with the home interest deduction and the charitable deductions and some other things. And, in effect, try to win your case on its merits because it is arguable on its merits. And I probably could make the argument both ways. But I hope that's the direction that you head.

On the issue of health insurance, fringe benefits, I think it isn't a matter of some folks who want tax-free benefits and those that don't. I have a quotation from the chairman last year in which he says: "If I thought the people who wanted to tax employee benefits really only wanted to make them more efficient, there would be room for negotiation."

And I take that to be the chairman's position. And it sounds to me, as I listen to this discussion, that an efficient, some kind of efficiency of the taxation maybe only of health insurance is on the table with regard to whether we come at it from the top, come at it from the bottom, or we come at it from the side. Do you have that same feeling?

Secretary **Baker**. Well, let me just say that as far as we are concerned, we would certainly be willing to be at the table, and, indeed, we are.

Senator **Durenberger**. Let me finish with a question where Bill Bradley left off. It appears to me when I look at the revenue estimates that you are not cutting too far into tax-exempt bond financing, particularly the private purpose bonds. And I come in that middle ground area, for example, on pollution control, hospitals. I think something like 60 percent or something like that of the hospitals use tax-exempt bonds. Could you clarify for me where you are headed?

Secretary **Baker**. Well, we are headed toward taking on the private purpose bonds, contrary to what you might gather from looking at the revenue tables, because the effect is felt in the outyears. It's basically the sales of future bonds.

We are not in any way suggesting eliminating or taxing the interest from general obligation bonds issued by any governmental authority. And we suggest a test of 1 percent private use there.

But I believe we also say in the proposal that we look forward to working with the tax-writing committees to refine that test.

Senator **Durenberger**. Are the hospitals in or out?

Secretary **Baker**. Well, it would depend on how it is constructed.

Senator **Durenberger**. Well, how would you define a hospital service? Is that a private use or a public use?

Secretary **Baker**. Well, I'm told hospitals would be out if it's a tax-exempt organization, under our proposal.

Senator **Durenberger**. Why does the——

Secretary **Baker**. Well, if there's a private use in there that exceeds 1 percent of the total use of the facility, as I understand it—this is a rough approximation of the test—then it will not qualify as a truly governmental obligation. If I enter into a contract to build a post office facility for Minneapolis and I lease it to the city, I'm not going to be able to finance that or do that deal on municipal——

Senator **Durenberger**. A public purpose——

Secretary **Baker**. That's not a public purpose because there's a private use, substantial private use, involved.

Senator **Durenberger**. Are you open to suggestion on this issue?

Secretary **Baker**. We said in the proposal, Senator, we expect and hope to work with the tax-writing committees with respect particularly to what the tests ought to be. But in some ways those things have been abused, and we want to try and cut out those abuses.

Senator **Durenberger**. All right. Thank you very much.

The **Chairman**. Senator Mitchell.

Senator **Mitchell**. Thank you, Mr. Chairman.

Mr. Secretary, at the conclusion of the last round of questioning, I asked whether the Treasury had considered an alternative plan which would significantly increase the amount of reduction available to middle class taxpayers. And you indicated that you had not.

Now Senator Danforth and I have been working on such a proposal, and I wonder if we submitted it to you in writing if you would give it serious consideration.

Secretary **Baker**. You bet, Senator.

Senator MITCHELL. I think it will accomplish a great deal of what the President's plan seeks to accomplish and do it in a more fair way. And in that regard, I note that according to Treasury's own document, the percentage tax reduction for persons with incomes of $200,000 or more is higher than for any other income category above $20,000.

And since this is calculated on family economic income, which as noted earlier, includes the rental value of a house someone owns, by the way in which almost every one actually reckons their income, you are really talking about people making as low as $13,000 or $14,000.

So I think that's the group that, as many Senators have expressed, really needs the tax relief. And you can provide them with greater relief by a more targeted personal exemption and by adding a fourth rate. There is, of course, nothing magic or principled about three rates. It's an arbitrary number. And there has been, as you know, some discussion—I believe there was in the House Ways and Means Committee—about having a 40-percent rate which would apply to income at a very high level, the benefits of which could be shifted to those in the middle-income brackets, those in the area of $15,000, $18,000, $25,000 a year. I wonder if you had considered that.

Secretary BAKER. A higher top rate, Senator?

Senator MITCHELL. That's right. A fourth bracket.

Secretary BAKER. We've been questioned about it since the idea surfaced over in Ways and Means, and, basically, we say that that is not something that we could agree to. The President has made it very clear that he does not want the top rate to be higher than 35 percent. To the extent that you start inching it up, you really defeat the purpose of tax reform. You make shelters more attractive. It's antigrowth and it's antisavings. And it would be, in our view, counterproductive. Furthermore, it would produce little or no revenue.

If I might, Senator, again I would like to dispel the notion that this proposal is not extremely fair for all taxpayers, including middle-income taxpayers. If you look again at chart 2 there, you will see that after all the middle income—we usually define as the $20,000 to $50,000 range—gets a 7.2-percent reduction whereas people over that get a 5.8. Now I know you can say people over $200,000 get 10.7.

Senator MITCHELL. That's right.

Secretary BAKER. That's going to happen, Senator.

Anytime you bring the top rate down, the top rate is going to get a significant reduction. There are two classes of people in that over-$200,000 group. There are people who pay a lot of taxes. Therefore, they are going to get a substantial reduction; and there are people who use a lot of shelters, and they are going to be out in the cold. And they are going to find that things are pretty tough for them.

But even if you took that $20,000 to $50,000 bar, Senator, and increased it—made it $20,000 to $70,000—you are talking about economic income so we are really not quite properly defining the middle class—go ahead and push it up to $70,000. You would then have a percentage tax reduction of 6.2 percent for the people in the

$20,000 to $70,000 bracket and only a 6.4-percent reduction for people over $70,000. It would be a wash, and it would be equally beneficial to the middle class.

Plus, you have the big reduction down at the lower end, the 18.3 percent for people under $20,000.

Senator **Mitchell**. Nobody quarrels with the point about the lower income.

Secretary **Baker**. Yes, sir.

Senator **Mitchell**. But if you look at this other chart, you see on economic income $30,000 to $50,000, the reduction is 6.6 percent. Now the problem is, Mr. Secretary, that what has happened in the last 4 years when we had an income tax reduction of 25 percent across the board every other Federal tax increased during that period. Virtually every other State and local taxes increased. The Social Security tax went up. The gas tax went up. Every excise tax went up. And as a consequence, those persons in the middle-income bracket, the working people, those who under this economic income would be somewhere in the range of 20 to 40, have overall seen their taxes go up. A policy has been pursued to reduce those taxes related to ability to pay and increase those taxes unrelated to ability to pay.

If I could just conclude, Mr. Chairman, with this comment.

When you now say they are getting a comparable reduction to those in the upper brackets, that is divorcing it from the history of the past 4 years when those in the upper bracket got very substantial tax relief in the 1981 plan and those in the middle income just about held their own after offsetting tax increases. I believe the middle class needs more relief than those above $100,000 to $200,000.

Secretary **Baker**. Senator we have two primary goals in this proposal, as I indicated in my statement. Fairness and growth. We think it's fair for the reasons I have outlined. You can't get growth, the kind of growth we have enjoyed over the past 31 months, if I might say so, unless you do bring that top rate down. And the minute you bring it down, you are going to give the very top bracket a substantial tax reduction.

Senator **Mitchell**. We've already brought the top rate down from 70 to 50 percent in 1981. If we bring it down to 40, that will be a nearly 50-percent reduction in the last 4 years.

Secretary **Baker**. If I may just say one final thing, Mr. Chairman. I think we ought to all be happy that we are debating—what we are debating here is the extent and scope of the reduction that everybody is going to get, of the benefit that everybody is going to get. And if I might suggest, it seems to me that these are differences only at the margin.

The **Chairman**. Senator Matsunaga.

Senator **Matsunaga**. Thank you, Mr. Chairman.

Mr. Secretary, would it be fair to state that your overall tax proposal is based on the old, old Democratic principle of taxation based on ability to pay?

Secretary **Baker**. I think it's fair to say that this proposal retains a progressive tax, Senator.

Senator **Matsunaga**. That it is a progressive tax.

Secretary **Baker**. It is a progressive——

Senator **Matsunaga**. Don't be afraid to say, Mr. Secretary—after all, your President is a convert. He was a Democrat. So it is ability to pay.

Secretary **Baker**. It is a progressive tax system. [Laughter.]

Senator **Matsunaga**. Well, I'm puzzled somewhat if that is your response about your proposal to subject to taxation the first $10 per month of employer-provided health benefits for individuals while exempting from taxation benefits above that amount. I would think that it should be in the reverse. The first $10 would be exempt to encourage savings and employers to provide health benefits and that you would tax what is above $10 to avoid the preference to the wealthy or those who can afford.

Secretary **Baker**. That was our original proposal, Senator Matsunaga. And as I indicated, I think, in an earlier answer, that proposal has been before this committee for 4 years, and it's obvious that its time simply hasn't come, so we have taken a different approach in that one area.

Senator **Matsunaga**. And are you saying that perhaps this might be an error? That your proposal might be an error?

Secretary **Baker**. Well, I think what I'm saying is that if the committee should choose to take a look at the approach that was suggested some 4 years ago, we would certainly be willing to discuss that with the committee, If there is a variation of this approach, it's something that we would be willing to talk about.

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. Mr. Chairman, I would just like for our side to say how much we have appreciated the Secretary's candor and the ease with which he handles complexity. Your tax simplification proposal runs about 450 pages. It's not a big document unnecessarily. Things are complex.

If I could just offer a closing thought. To my understanding, the single most important proposal you have made with respect to real impact on individual family lives is to increase the personal exemption to $2,000, which is still well short of what it would have been had we just maintained the value of the levels of 1948, and indeed had we let that 1948 $600 exemption be continued as a percent of per capita income, it would be $5,600.

Secretary **Baker**. Yes, sir.

Senator **Moynihan**. Well, hats off to you. You all did it and nobody else did. Let's see if we can keep that. It will be worth the year we are going to spend on it in my view.

Thank you, Mr. Secretary.

Secretary **Baker**. Thank you, Senator.

The **Chairman**. Let me, if I might, put in perspective this fringe benefit medical insurance issue. I don't think it's unknown to this committee what my views are on taxing basic employee benefits, whether they are legal care or education or day care, insurance or health care. And the Secretary and I have had some extensive discussions on the subject.

As we looked at Treasury 1, both education, employer provided education and employer-provided legal care, would terminate at the end of this year. And they would be automatically taxed fully—income and Social Security, unless Congress re-extended them and the administration approved of it. The administration vetos it, we would have full taxation of both those benefits.

Treasury 1 recommended the end of the tax-free status of employer-provided day care and the end of the tax-free status of $50,000 of life insurance provided by employers. Those are both now recommended for extension by the administration. And when we talked about health benefits, I felt very strongly that if they wanted to attempt to tax a cap, they would not get any money. What would happen is, indeed, the cap would work and the benefits would not be over that, and you would drop out eye care and dental care and the other more expensive health care that has come aboard in the last 5 or 10 years. And, instead, those benefits would be moved over to other tax-free employee benefits, and the administration would realize no money at all.

Under a carefully worked out compromise, not only involving the administration and myself, but some of the leaders of organized labor, the administration's present proposal was adopted. And at least among those who are affected, it has broad support. And I would hope that the administration will stick with their position and that this committee will stick with their position because if we return to the cap, the whole program and perhaps the whole tax bill is going to become unravelled.

Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Secretary.

The CHAIRMAN. Senator Mitchell. I'm sorry.

Senator MITCHELL. Mr. Secretary, reference has already been made to your decision with respect to the intangible drilling cost in oil and timber. And I come from a State which is 91 percent forest, the highest percentage of any State in the Union, and in which that represents by far the most important basis of our economy. It is a fact of history and natural development that different regions of the country are blessed with different natural resources. And we are very much concerned about that aspect of the proposed legislation.

And I have a series of questions all relating to that which I would ask and then you could handle them in narrative.

But why does the administration believe that assets held for 6 months should enjoy preferential tax treatment over assets such as timber which is held for 30 or 40 years or more? Why does the administration preserve preferential tax treatment for such nonproductive assets as paintings, jewelry, gold, collector stamps, while repealing capital gains treatment for what is an important natural resource such as timber?

Now this administration—the present administration—has estimated that commencing in 1990 and extending for a period of at least 30 years this nation will be unable from domestic resources to meet the demand for timber. And, obviously, the proposal that you make will have a truly disastrous effect and cause that inability to meet demand to be even greater. Have you considered this? And I would like very much to know because it's a matter of great concern to me and I know other members of this committee whether you would consider modification of that provision, if we can make the case to you.

Secretary **Baker**. Well, Senator, we have considered this and we talked to many, many representatives of the forest products industry. And in some ways, there is a very compelling argument. It's our view that the distinction here—I mean basically capital gains for timber violates in our view at least the distinction between investment property and business property. The items that you mentioned from a tax policy standpoint now, the items that you mentioned, I think, are more appropriately categorized as investment property as opposed to business property.

If I'm not mistaken, one of the major objections of the industry to the proposal is that we require the capitalization of preproduction costs.

Senator **Mitchell**. That's right.

Secretary **Baker**. And there it is simply our view that where a taxpayer produces property that is not sold in the current year, that's the appropriate tax treatment to give that property. The costs of production should not be deducted currently well in advance of the sale of that property.

Senator **Mitchell**. How does that argument apply to the oil industry?

Secretary **Baker**. Oil is sold as ordinary income, Senator.

Senator **Mitchell**. No. I mean with respect to intangible drilling costs.

Secretary **Baker**. Well, they are taken as it is produced.

Senator **Mitchell**. You can expense it. You don't have to capitalize it.

Secretary **Baker**. That's correct. Yes, sir. But that's because the property is, with respect to successful wells, sold at the time they are taken.

The **Chairman**. But you can also expense even for unsuccessful wells.

Secretary **Baker**. That's correct.

Senator **Mitchell**. That's right.

I just say to you that this is a far-reaching proposal that——

Secretary **Baker**. Excuse me. You can expense for unsuccessful timber stand too.

The **Chairman**. Well, you can under the present law. Not under the proposal.

Senator **Mitchell**. That's the difference. We are talking about the proposal. It treats one category differently than another.

I just say to you that there will be many effects from this legislation, some of which can be foreseen, some of which inevitably nobody can foresee. This is an effect which can now be foreseen. And will be disastrous for the timber industry.

Secretary **Baker**. I would be quick to acknowledge, Senator, that is a persuasive argument.

Senator **Mitchell**. Mr. Secretary, I just have two brief questions which I would like to ask.

First, the plan, as proposed, would increase the amount that can be contributed to individual retirement accounts by nonworking spouses. Have you developed any figures to show how this benefit would be distributed across income classes?

Secretary **Baker**. Not as far as I know, Senator. No, sir, we don't. But if you would like to have some, we will work some up.

Senator MITCHELL. I would appreciate it if that is not too much of a burden. I know you've been asked to produce a lot of things here.

[The information from Secretary Baker follows:]

ESTIMATED DISTRIBUTION BY FAMILY ECONOMIC INCOME CLASS OF THE ESTIMATED TAX CHANGE RESULTING FROM THE PRESIDENT'S PROPOSAL TO INCREASE THE SPOUSAL IRA LIMIT FROM $250 to $2,000 CURRENT TAX RATES APPLY

[1983 levels of income]

Family economic income class	Tax change		
	Amount (in millions of dollars)	Percentage distribution	Cumulative percentage distribution
Less than $10,000	(1)	(1)	(1)
$10,000 to $15,000	−3	0.4	0.4
$15,000 to $20,000	−4	.7	1.1
$20,000 to $30,000	−19	2.9	4.0
$30,000 to $50,000	−139	20.8	24.7
$50,000 to $100,000	−357	53.3	78.0
$100,000 to $200,000	−105	15.7	93.7
$200,000 or more	−42	6.3	100.00
Total	−670	100.0	

[1] Less than $50,000 or 0.05 percent.

Source: Office of the Secretary of the Treasury and Office of Tax Policy, September 24, 1985.

Senator MITCHELL. I have a number of others, but I will ask just one more.

On Sunday, Mr. Buchanan was quoted in the New York Times as saying that the President's tax reform plan was designed to favor the traditional family, which he characterized as one where the husband works and the wife stays home and takes care of the children. You are one of, if not the principal, architect of this plan so I ask you. Was the President's plan designed to favor the traditional family defined as one where the husband works and the wife stays home and takes care of the children?

Secretary BAKER. Well, I think as we have said before,

Senator, it was a plan designed to favor the family, and it is pro-family. And I don't think it's productive for me to get into the debate about what does or does not constitute a family. [Laughter.]

Before you wind it up, Mr. Chairman, I was simply going to say that I want to make sure that you understand and the committee understands the President sticks by all the elements of this proposal, including those elements with respect to the taxation of health care benefits. And in my remarks, all I'm really saying is if a majority of the committee comes to us, obviously, we are going to be willing to discuss anything that the committee wants to discuss.

The CHAIRMAN. We all have a tendency to generalize in this world, and I hope you wouldn't think that three or four is a majority.

Secretary BAKER. No, sir. Absolutely not.

Senator MOYNIHAN. I don't know if——

[Laughter.]

The CHAIRMAN. Fortunately, we are talking about different issues.

Mr. Secretary, good job. We are delighted to have you with us.

Secretary **Baker**. Thank you, Mr. Chairman.

[Whereupon, at 12:56 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

QUESTIONS FROM SENATOR DAVID BOREN

Question 1a. Under the administration's proposal, an investor who bought stock in a publicly-traded timber company from another investor would be taxable on any gain at a rate of no more than 17½ percent. Similarly, a speculator who bought a regulated futures contract in lumber would be taxable on any of his gain at a rate of no more than 24½ percent. By contrast, a timber owner who planted timber and held it until harvest decades later would, under the proposal, be taxable at up to 35 percent.

If the proposal is intended to stimulate economic growth, why does it tax people who exchange pieces of paper among themselves up to twice as favorably as those who are actually responsible for economic growth?

Question 1b. Is it fair to tax income from the sale of stock held for six months or income from the sale of a futures contract held for one day at preferential rates, while taxing timber grown over 40 years at high ordinary rates?

Answer 1a. One way in which the proposal will stimulate economic growth is by reducing differential tax treatment across industries so that investment decisions are motivated by productivity concerns rather than the tax law. Accordingly, income from timber (and other section 1231 property) used in a trade or a business will be taxed at ordinary rates, as is all other income from property used in a trade or business. Thus, preferential treatment for timber will be eliminated, and corporate income from timber will be taxed at maximum rate of 33 percent, and individual and partnership income from timber will be taxed at a maximum rate of 35 percent.

Investors who own timber indirectly will not escape the taxation of income from timber at ordinary rates, since the value of their securities will reflect the present value of after-tax returns from direct investment in timber. Thus, preferential tax treatment of capital gains on claims to timber income does not imply a tax advantage relative to direct ownership. Instead, capital gains treatment on timber investment assets, coupled with ordinary income treatment for timber business property (and other special section 1231 property), merely extends to timber the same treatment which is applied to all other business and investment assets. The continuation of capital gains treatment for investment assets is recommended by the Administration in order to encourage indirect investment and thus stimulate growth.

Answer 1b. The relevant distinction is between investment assets and assets used in a trade or business. The Administration proposes to maintain preferential capital gains treatment for investment assets in order to stimulate investment and economic growth, while taxing the income from business assets which generate such capital gains at ordinary rates which are considerably reduced relative to current law. Given this decision, taxing at ordinary rates the income from timber (and other section 1231 assets) used in a trade or business is fair and also promotes economic efficiency, as it ensures that all assets used in a trade or business will receive the same tax treatment.

However, note that the Administration's proposal reduces the tax differential between capital gains and ordinary income significantly. Under current law, ordinary income is taxed at a maximum rate of 50 percent, while capital gains are taxed at maximum rate of 20 percent; this results in differential of 30 percentage points. Under the administration's proposal, this tax differential will be reduced to 17.5 percentage points (35 − 17.5).

QUESTION ON DEPENDENT CARE FROM SENATOR DOLE

Question. Why did you decide to turn the dependent care credit into a deduction when the administration had earlier proposed to target the credit and make it larger for lower and middle-class individuals?

Answer. The Administration's proposal to change the child care credit to a deduction recognizes that child and dependent care expenses constitute legitimate costs of earning income which affect a taxpayer's ability to pay taxes. A family with $30,000 of income and $2,000 of employment-related child care expenses does not have greater ability to pay than one with $28,000 of income and no such expenses. The Administration's proposal thus provides tax relief for taxpayers at all income levels who incur child care costs.

The current credit for child and dependent care expenses and the Administration's budget proposal target the benefits to low-income taxpayers. With a given tax rate schedule, it may be desirable to target the cost of a child care allowance in this manner in order to provide additional tax relief to low-income taxpayers. When rate schedules can be changed at the same time, any degree of tax relief can be established at any income level. Under the Administration's tax reform proposals it was not necessary to target tax relief through the credit, because additional tax relief is provided for low-income taxpayers through lower tax rates, larger zero bracket amounts, and larger personal exemptions.

Question. I understand that accelerated depreciation taken since 1979 just changed when income would be recognized and that businesses that bought depreciable assets expected to pay tax at 48 or 46% when the deferred income was eventually taxed. However, I am unclear as to why you chose to recapture the benefit of the lower rates over three years, rather than some longer period.

Answer. The windfall recapture tax is properly viewed as a transition provision designed to ensure that the benefits of rate reduction are better targeted to new investment. As your question implies, it would have been theoretically proper in certain circumstances for the recapture to be taken over a period longer than three years. However, we do not believe that a transition rule of this sort ought to be effective for an extended number of years. Thus, we compressed the recapture tax into a three-year period. If it is demonstrated that there are circumstances in which this three-year period is overly compressed, we will consider recommending to the tax-writing committees that the period be appropriately modified.

Question. Many shelters are based on tax deferral and the proposed repeal of the investment tax credit and at risk exception for real estate, as well as the slowdown in depreciation, should do much to reduce the attractiveness of these shelters. However, other shelters are based on converting ordinary income into capital gain income taxed at lower rates. What efforts have you made to reduce the availability of these shelters?

Answer. Under current law, certain expenditures that create capital assets are deductible from ordinary income, even though the recovery of those expenditures through sales or exchanges of the assets gives rise to capital gains taxed at reduced rates. This result is referred to as "conversion", since such transactions have the effect of converting the investor's ordinary income into capital gains.

Conversion results, under current law, from a variety of activities, including investments in timber, farming, and real estate. In timber transactions, a limited amount of reforestation expenditures, as well as expenditures related to growing timber, are currently deductible, although in many cases the sale or exchange of timber gives rise to capital gains. Certain expenditures relating to the clearing, conservation, and enrichment of farmland are also currently deductible from ordinary income, although a sale of appreciated farmland ordinarily gives rise to capital gains. Depreciation of buildings, as well as expenditures to prevent their deterioration, are currently deductible from ordinary income, although gain from the sale or exchange of a building is in many cases treated as a capital gain even to the extent that the building's basis has been reduced through deductible depreciation.

The President's tax reform proposals would substantially reduce the availability of conversion. Under the proposals, expenditures that enhance the value of farmland generally would be capitalized as a cost of the land, and reforestation and timber growing expenditures would be capitalized as a cost of the timber. Additionally, sales or exchanges of timber would give rise to ordinary income unless the timber constituted a capital asset in the hands of the taxpayer. Although depreciation and maintenance expenditures relating to buildings would continue to be deductible from ordinary income, no part of the gain from the sale or exchange of a building (or other depreciable property) would be treated as capital gain.

QUESTION ON COAL DEPLETION RULES FROM SENATOR HEINZ

Question. Coal Provisions: repeal of Percentage depletion—Percentage depletion is the coal industry's equivalent to oil and gas intangible drilling costs. Percentage depletion is critical to maintaining coal's competitive edge which is essential to putting this country solidly on a domestic energy basis.

What is Treasury's rational for eliminating the Coal depletion rules at the same time retaining the IDC for oil and gas?

Won't this additional burden reduce capital investment and productivity and thus endanger national security?

Answer. Percentage depletion is basically an incentive to maintain or increase production from existing reserves. Of course, percentage depletion also may incidentally serve as an incentive to encourage exploration for new reserves of oil or coal, but as such, it is far less efficient as an incentive than the ability to expense intangible drilling costs or hard mineral exploration and development costs.

The loss of percentage depletion may indeed result in the premature abandonment of a marginal well or mine. However, the consequences of abandonment are not the same for both types of deposits. Once a stripper well is abandoned, it is very likely that the remaining oil or gas reserves will be lost. This in not necessarily the case with a coal mine, which may more readily be reopened if future coal prices justify such action.

Despite the ultimate loss of percentage depletion, Department of Energy (DOE) estimates indicate that only about a 1% increase in the price of coal would be needed to retain the level of profitability of existing mines under the President's tax proposal. DOE also estimates that the direct impact of the proposals on the profitability of new mines is somewhat more adverse, but even for such mines a 5%-10% increase in the minemouth price of coal (or a corresponding reduction in costs) would restore profitability. In view of this modest estimated impact on the profitability of both existing and new coal mines, it does not appear as if the nation's energy security would be endangered by the President's tax reform proposal.

Question. Treasury's new proposal includes a recapture tax designed to raise $57 billion from people who invested as you wanted them to under our 1981 tax bill. Why are they singled out? If your theory is correct, shouldn't you have a similar recapture proposal for every accelerated deduction or income deferral contained in the Code?

Answer. It is true that the theory of the recapture tax suggests that various types of deferred income, and not just income deferred as a result of accelerated depreciation deductions, should be subject to the windfall recapture tax. In other contexts, however, the deferred income is not so readily identifiable or of such magnitude as that caused by accelerated depreciation. Nevertheless, the Administration has not foreclosed the possibility of including other types of similarly deferred income in the windfall recapture tax base and would be willing to work with the appropriate staff personnel to broaden the windfall tax if you so desire.

Question. Isn't it wrong to say that corporations and individuals expected to repay their deferred liabilities attributable to ACRS at a 46% rate, when in fact most companies will continue to invest in capital equipment and will create a stream of deferral?

Answer. Any company continually investing in equipment eligible for ACRS creates a stream of deferral by virtue of the stream of cost recovery deductions. The windfall recapture tax, implemented through a mechanism that requires an income inclusion in years after the rate reduction, certainly alters the expected stream of deductions. But for a company in a tax-paying position the adjustment merely requires that the company pay tax on the deferred income at a 46% rate, instead of a 33% rate. For companies making substantial capital investments in later years, the cost recovery allowances from those investments may serve to further defer some or all of the income inclusion required by the recapture proposal. The expected level of future investment, however, should not influence efforts to ensure that the previously deferred income is taxed at a 46% rate.

QUESTION ON TAXATION OF CASH VALUE ACCUMULATIONS IN LIFE INSURANCE FROM SENATOR HEINZ

Question. Congress just spent two years studying, and establishing a system for the taxation of life insurance companies and policies. At that time Treasury did not support the notion of taxing "inside buildup" at the corporate level or at the shareholder level.

What is the rational for taxing "inside buildup" at the policy holder level?

How do you justify taxing this "phantom" gain at the shareholder level? Isn't it the same as taxing a homeowner on the appreciation of his home? This is taxing income that people have never received, is it not?

Has Treasury considered the impact that this will have on the ability of the elderly to purchase life insurance?

Answer. Although such comparisons are possible, we do not think they are relevant for purposes of evaluating the taxation of the investment income on new life insurance policies. The question of whether the income earned on investments should be subject to current taxation should not depend on whether it is a good or bad investment vis-a-vis alternative investments.

Increased competition for the savings dollar has forced life insurance companies to develop new products, such as universal life, that provide policyholders with rates of return roughly comparable to market returns from alternative investments. Before the increased competition, saving through life insurance was still attractive even though pretax rates of return were considerably lower because the investment income was not subject to tax currently and completely exempt from tax if held until death. Now, with certain new policies, policyholders can chose to have their cash value invested in mutual funds or Treasury securities, yet still pay no tax currently.

Question. Repeal of ITC and ACRS—Treasury's proposal will increase the cost of capital investment for manufacturing in the U.S. Further, other countries provide more favorable cost recovery systems.

Aren't we providing a positive incentive for U.S. companies to move their manufacturing facilities abroad?

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

September 17, 1985

Response to Senator
Heinz' questions.

Bob

Dear ~~Mr. Chairman~~:

I would like to offer some thoughts on the likely impact of the President's tax reform proposals on the ability of U.S. companies to compete in international markets. Some U.S. businesses have expressed concern about that issue, and in particular have claimed that the proposed U.S. cost recovery system would be much less favorable than the tax systems of our major competitors.

The tax treatment of depreciable assets is one of many factors which businesses consider in evaluating an investment decision. We have looked at the capital cost recovery systems, the tax rate, and the overall tax burden in five of our major trading partners (Canada, France, Germany, Japan, and the United Kingdom) and compared them with those in the United States under the President's tax proposals. Our conclusion is that the U.S. corporate tax burden would remain low by international standards.1/ The following comments elaborate on these points.

In terms of present value (i.e., the discounted current value of all deductions claimed over the period required to recover the cost of an asset), the proposed U.S. system compares very well. In terms of nominal annual allowances, the proposals generally provide less benefit in the first few years. That is not a consequence of moving from ACRS to CCRS depreciation deductions, but of correcting the distortions caused by negative tax rates generated by the investment tax credit.

Critics of the Administration's proposals have charged that the proposed changes in the U.S. capital cost recovery system would put us "dead last in the industrialized free world." This charge was based on figures compiled by Arthur Andersen & Company. However, the Arthur Andersen figures for the present value of depreciation deductions and investment tax credits in our five major trading partners (Canada, France, Germany, Japan, and the United Kingdom) show the Administration's proposal not as "dead last" but as third of the six countries with respect to equipment

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1/ The attached chart (following the tables) summarizes some of the principal features of the tax systems of these five countries, the United States under current law, and the tax-reform proposals.

and a close second for structures.2/ Moreover, those figures ignore statutory changes already enacted that will make the 1986 figures for the United Kingdom and France lower than reported. They also assume a more rapid write-off of equipment in France than other sources indicate. Once those adjustments have been made to the figures for the United Kingdom and France, the Administration's proposal ranks second of the six for equipment and first for structures. (See Table 1.) It is important to also consider the treatment of structures, as investment in plant is an important part of any capital intensive firm's assets.

We have also looked at the "cash flow" effects of capital cost recovery allowances, meaning in this case the nominal value of the deductions year by year. The allowances in the first year or two are substantially higher in some of the countries than in the U.S. proposal, although over a five year period the differences are much smaller. (See Table 2.) However, even in the first two years, the CCRS depreciation allowances are as generous as the existing ACRS allowances (excluding the investment tax credit). Moreover, the proposed allowances are sufficiently generous to more than offset the income likely to arise from the asset acquired. For example, the CCRS deduction for class 4 equipment is 22 percent. Assuming that the equipment is placed in service on January 1 and yields a reasonably high pre-tax profit of 15 or 20 percent, the depreciation deduction at 22 percent will more than offset the income produced. A higher deduction could only be used to reduce tax on income from other assets.

More importantly, comparing depreciation deductions tells only part of the story. Even a businessman who focuses on the way the tax laws affect his company's "cash flow" would recognize two things that are not apparent from Table 2. First, the depreciation deductions are of no immediate value unless his company has sufficient income against which these deductions may be offset. Second, to the extent his company has additional taxable income (i.e., is profitable), the rate of tax is equally important as a determinant of "cash flow". The proposed U.S. corporate tax rate of 33 percent would be the lowest among those

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2/ The Arthur Andersen figures cover 14 countries plus the U.S., ranking them in descending order as follows: Luxembourg, Belgium, Canada, France, Hong Kong, Denmark, the U.S. proposal, Sweden, Italy, the United Kingdom, Germany, Switzerland, South Korea, Japan, Taiwan. One has to wonder at the relevance of a comparison which suggests that, of fifteen countries, the three least able to compete in international markets are South Korea, Japan and Taiwan.

of the six countries considered (Canada, France, Germany, Japan, the United Kingdom and the United States). Even if an estimate of income taxes collected by political subdivisions is also factored in, the U.S. tax burden remains relatively low. (See Table 3.)

To put this discussion in a more general context, one should also look at the overall tax burden in the various countries and how it is collected. Compared to our major trading partners, the United States is a low tax country. As of 1982, we ranked fifth of the same six countries, the next to the lowest, both in overall tax burden and corporate income tax burden. Japan had the lightest overall tax burden, but the highest burden of corporate income tax. (See Table 4.) Under the Administration's proposals we would continue to be a low tax country compared to our major trading partners.

Finally, even when one considers all aspects of the tax -- base, rate, and overall corporate tax burden -- it is unwise to jump to conclusions. As noted above, Japan has the least generous capital cost recovery provisions and the highest corporate tax burden, yet Japanese manufacturers manage to compete very well internationally. The explanation is that corporate taxes, although clearly a factor in investment decisions, are a small fraction of total corporate costs. The U.S. corporate tax amounts to not more than three percent of total costs, on average, for manufacturers; the President's proposals would not change that relationship. Economic conditions, such as the strong dollar, dwarf taxes as an influence on international competitiveness. Since 1980 the cost of the dollar has risen more than 40 percent compared to foreign currencies, and swings of 3 percent frequently occur in a matter of weeks. Thus, it would be very unusual for the lower tax in Canada on certain investments in equipment to outweigh the other costs (including tax treatment of structures and the tax rates) incurred in producing there for export.

Moreover, the wisdom of Canada's system of rapid write-offs of investment and an investment tax credit, paid for by a relatively high tax rate, is being questioned by the Canadian Government. The Finance Minister recently published a discussion draft of proposals to repeal the investment tax credit, modify the depreciation scheme, and reduce the corporate tax rate (The Corporate Tax System; A Direction for Change, May 1985). The discussion draft cites the examples of the recent U.K. rate reduction and the U.S. proposals.

In short, we should expect companies which have been paying little or no tax -- or better yet, getting refunds -- to complain at being asked to pay more, but it is important to put their complaints in perspective. We recognize that in some cases companies may owe little tax because they have had a bad year.

Therefore, we propose to retain generous rules for loss carryovers and to reduce the rate of tax that will apply when they become profitable.

I hope this explanation will be helpful in assessing how the President's tax proposals would affect the ability of U.S. companies to compete with companies based in other countries. The charge that the proposals will destroy U.S. competitiveness is not supported by the evidence presented. Even evidence submitted by those who make this argument actually suggests that the United States tax climate will remain attractive for U.S. industry.

Sincerely,

Jim

James A. Baker, III

The Honorable
Bob Packwood, Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Enclosures

Table 1

Comparison of Capital Cost Recovery Systems

Discounted present values of cost recovery systems as calculated by Arthur Andersen & Co. 1/ for 1985

	equipment			structures	
	present value	rank		present value	rank
Canada	96.3	1	United Kingdom	58.5	1
France	85.1	2	U.S. (CCRS)	58.1	2
U.S. (CCRS)	83.4 2/	3	Canada	49.6	3
United Kingdom	79.4	4	France	39.3	4
Germany	77.7	5	Germany	37.3	5
Japan	69.0	6	Japan	35.7	6

Adjusted discounted present values of cost recovery systems, 1986 3/

	equipment			structures	
	present value	rank		present value	rank
Canada	96.3	1	U.S. (CCRS)	58.1	1
U.S. (CCRS) 2/	83.4 2/	2	Canada	49.6	2
Germany	77.7	3	France	39.3	3
France	76.0	4	United Kingdom	39.3	3
United Kingdom	73.5	5	Germany	37.3	4
Japan	69.0	6	Japan	35.7	5

1/ Prepared for the Committee for Effective Capital Recovery, which made the study public. These figures assume a 4 percent real growth and 5 percent inflation. They also assume that the property is placed in service on January 1, and the deduction is discounted the first year. (Treasury Department calculations of present values typically do not discount the first year and therefore result in higher numbers, but the same rankings. To avoid confusion, the practice used by Arthur Andersen & Co. has been followed here.)

2/ Class 4 equipment, with a seven year recovery period. For class 3, with a five year period, the number would be 85.8.

3/ Data in prior table updated to 1986 for the United Kingdom and France. In both cases initial allowances formerly available cease to apply for equipment placed in service as of 1986 or later. In addition the figure for France was recalculated assuming the declining balance method at 2.5 times the straight line rate of 10 percent as reported by some other sources. The Arthur Andersen figures assume a double declining balance and a 5 year life.

Table 2

Timing of Depreciation Deductions and ITC Benefits

	Nominal value of cumulative annual deductions as percent of cost of investment (assuming 5% inflation)		
	equipment		structures
	2 years	5 years	5 years
Canada	89.2%	112.5%	38.6%
France (1986)	51.2	79.4	20.0
Germany	51.0	83.2	25.0
Japan	37.0	68.5	20.0
United Kingdom (1986)	43.8	76.3	20.0
U.S. (CCRS) 1/	39.3 2/	82.4 2/	20.3

1/ These figures do not conform to those shown in Table 7.01-3 of The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity. For consistency with the other country data they assume the asset was placed in service on January 1. Table 7.01-3 follows the convention used in Treasury estimates of assuming a July 1 service date.

2/ Class 4 equipment with a seven year recovery period. For class 3, with a five year period, the numbers would be 55.3 (2 years) and 95.9 (5 years).

Source: Tables prepared by Arthur Andersen and Company for the Committee for Effective Capital Recovery, adjusted for France and the United Kingdom as indicated in footnote 3 to Table 1.

Table 3

Statutory Corporate Tax Rates

	National	All levels of government
Canada	40-46[a]	40-51[a]
France	50	50
Germany	36/56[b]	40/63[b]
Japan	33.3/43.4[c]	46/57[c]
United Kingdom (1986)	35	35
U.S. proposal	33	40[d]

a. The portion of income from manufacturing and processing in Canada (but not from sales or services) is taxable at the lower rate. The national rate includes a 10 percentage point abatement for provincial taxes which typically range from 10-15 percent; thus such taxes may not affect the national rate in some cases and in others will increase it by 5 percentage points.

b. National tax of 36% on distributed and 56% on retained profits. Local tax of approximately 15% is deductible for the national tax.

c. National tax of 33.3% on distributed and 43.4% on retained profits. Also prefectural and municipal income taxes, some deductible for national tax. Combined rate approximately 46% on distributed and 57% on retained profits.

d. Assumes a 10 percent state and local income tax liability on the Federal tax base, which considerably overstates the tax in most states.

Table 4

Revenues as a Percent of Gross Domestic Product, 1982
(and rank)

	Total taxes	Corporate taxes	Individual income tax	Social security taxes	Other
Canada	34.8% (4)	2.8% (3)	12.4% (1)	3.9% (6)	15.7% (3)
France	43.7 (1)	2.2 (4)	5.6 (6)	19.8 (1)	16.1 (2)
Germany	37.3 (3)	1.9 (6)	10.8 (4)	13.5 (2)	11.1 (4)
Japan	27.2 (6)	5.4 (1)	6.9 (5)	8.3 (4)	6.6 (6)
United Kingdom	39.6 (2)	3.8 (2)	11.2 (3)	8.0 (5)	16.6 (1)
U.S. (current law)	30.5 (5)	2.1 (5)	11.5 (2)	8.4 (3)	8.5 (5)

Source: Organization for Economic Cooperation and Development, Revenue Statistics of Member Countries, 1965-83, (Paris, France), 1984.

COMPARATIVE SUMMARY OF SOME FEATURES OF CORPORATE INCOME TAXES

COUNTRY	CANADA		FRANCE	GERMANY	JAPAN	UNITED KINGDOM (1986)	UNITED STATES	
	current law	discussion draft proposals					(current law)	Administration Proposal
Corporate tax rate								
national	46%; or 40%[1]	39% or 33%[1]	50%	36%/56%[14]	33.3%/43.4%[20]	35%	46%	33%
estimated total	46-51%, or 40-45%	39-44%, or 33-38%	50%	40%/63%[14]	46%/57%[20]	35%	51%[28]	40%[28]
Dividend relief								
form	credit[2]	credit[2]	credit[9]	split rate, credit[15]	split rate, credit[21]	credit[25]	no	10% deduction
% of double tax relieved	40-50%	40-50%	50%	100%	40%	80%	——	10%
Accelerated depreciation of equipment								
expensing	no	no	no	no	no	no	no	no
other	3 years[3]	25% declining balance	20% double declining balance[10]	30% declining balance[16]	20.6% declining balance	25% declining balance	ACRS	CCRS, indexing
Investment tax credit	7%	no	no	no	7%; limited[22]	no	generally 10%	no
Present value of depreciation & ITC benefits[4]								
equipment	104%[5]	80%	83-90%[10]	85%	76%	80%[26]	102%	90%
structures	52%[5]	37%	43%[11]	41%[17]	39%[23]	43%[26]	56%	62%
Capital gains								
% taxed at ordinary rate	50%	50%	30%[12]	rollover[18]	100%	6/7	40%	50%
indexed	no	no	no	no	no	yes	no	elective, 1991[30]
R&D incentives								
expensing								
equipment	yes[6]	yes[8]	no	no[19]	no	yes[27]	no[29]	no
other	yes[6]	yes	yes	yes	yes	yes[27]	yes	yes[31]
tax credit	20-35%[7]	20-35%	25% incremental with cap[13]	no	20% incremental with cap[24]	no	25% incremental	extended 3 years, targeted[32]

Office of the Secretary of the Treasury
Office of Tax Analysis

August, 1985

Notes

1. The reduced rate applies to Canadian manufacturing and processing. The national tax is reduced by a credit for a 10% provincial tax. Provincial taxes are typically 10-15%, so the combined rate ranges from the national rate to 5 points higher.

2. Resident shareholders include in income and claim as a credit an amount equal to 34% of the net dividend received. The credit is not refundable.

3. Equipment used in Canadian manufacturing and processing may be written off over three years.

4. Assumes equity-financed investment, 4% real growth and 5% inflation. For ease of comparison among countries, it is assumed in each case that the property is placed in service on January 1. The ACRS calculation uses a mid-year convention and the CCRS calculation a mid-month convention.

5. Assumes 7% investment tax credit is available for structures. 50% declining balance method. Investment credit converted to a deduction at 36% rate.

6. Scientific research and development costs incurred within Canada.

7. Rate varies by province in which investment is made. Applies to buildings, equipment, related expenses (e.g. salaries of researchers) used for scientific research in Canada. Alternatively, investors in R&D firms may claim a tax credit of 50% of such investments for corporate investors and 34% for individuals.

8. However, this is one of the areas specified for further examination.

9. Resident shareholders include in income and claim as a refundable credit an amount equal to one-half the dividend received.

10. The 90% figure is based on information from Arthur Andersen, Inc. that France permits double declining balance and a five year life for machinery and equipment. Some other sources report the declining balance method at 2.5 times the straight line rate of 10% which would reduce the present value to 83%. A special first year allowance of 40% of the ordinary depreciation applies to assets placed in service in 1985, but not in 1986 or thereafter; it is not reflected in these figures.

11. Assumes 25 year straight line depreciation.

12. Gains on assets held longer than two years taxed at 15% (cf. ordinary rate of 50%). The balance of tax otherwise due must be put in a special reserve and paid over as tax when the reserve is distributed, i.e. the tax is deferred.

13. Tax credit equal to 25% of excess of qualifying expenses over the prior year for expenses incurred 1983-1987 up to a maximum credit of 3 million francs (about $300,000) per year. Prior year expense is indexed for inflation. Excess credit is refundable. A decline in expenses reduces credit available in the following year (or is recaptured if no credit may be claimed in that following year). Due to expire 1987.

14. National tax 36% on distributed and 56% on retained profits. Local tax of approximately 15% is deductible from the national tax base.

15. Resident shareholders include in income and claim as a (refundable) credit 36% of the dividend received.

16. Accelerated depreciation allowed for anti-pollution equipment, mining equipment, R&D capital expenses and assets used in West Berlin or along the East German border. Otherwise declining balance at 3 times the 10% straight line rate assumed used in years 1-5, straight line thereafter.

17. 50 years; 5% straight line for the first 8 years, then 2.5% for 6 years and 1.25% for the remaining 36 years.

18. Taxed as ordinary income, but gains on land and buildings exempt; gains on involuntary conversions rolled over, and 80% of gains on sale of corporate securities and long-lived assets rolled over. Rollover requires acquiring new assets within two years.

19. However accelerated depreciation of up to 40% declining balance for five years is allowed on movable capital assets used wholly for R&D. In addition, cash grants may be available of 20% of the first DM 500,000 (about $150,000) and 7.5% of the excess cost of fixed capital assets used for R&D.

20. National tax 33.3% on distributed and 43.3% on retained profits. Also prefectural and municipal income taxes, some deductible for national tax. Combined rate approximately 46% on distributed and 57% on retained profits.

21. Resident shareholders may claim a credit equal to 10 percent of the dividends received. The credit is not included in income.

22. Taxpayers may elect: (i) a credit equal to 7 percent of the cost of energy-saving equipment or equipment (e.g. robots) to modernize small and medium businesses, or (ii) a 30% first year depreciation of such equipment.

23. 5% declining balance.

24. 20% of excess of qualifying R&D expenses over those of any prior year since 1966 may be credited against corporate tax. The credit is limited to 10% of the pre-credit liability.

25. Resident shareholders include in income and claim as a refundable credit 3/7 of the dividend received.

26. 25% declining balance for equipment and 4% straight line for buildings. No first year allowances are available as of 1986. In 1985, a first year allowance is available at 50% for equipment and 25% for buildings; this would raise the discounted present values to 87% and 63%, respectively. (In 1984 the initial allowances were higher and in 1983 expensing was allowed, so in those years the discounted present values would have been still higher.)

27. "Scientific research" expenditures continue to be eligible for a 100% first year allowance.

28. Assumes a 10% state tax, deductible for Federal tax purposes.

29. Accelerated depreciation is available; five-year assets may be written off in three years.

30. Beginning in 1991, individuals could elect to index capital gains for inflation as an alternative to the preferential rate produced by the exclusion.

31. Certain costs attributable to multi-period projects would be subject to the multi-period accounting rules.

32. The incremental 25% credit would be extended for three years (through 1988) but revised to target research activities likely to produce technological innovations.

QUESTION ON SOCIAL SECURITY FROM SENATORS GRASSLEY AND MOYNIHAN

Question.—Has the Treasury Department estimated the effect that base broadening will have on Social Security tax liabilities? I am concerned that individuals earning less than the base amount will find that their social security taxes are increased, while the marginal tax rate on their income has not correspondingly decreased. Was this factor considered in your revenue estimates? I am worried that those middle income people for whom we are trying to make the tax system more fair will bear the incidence of higher social security taxes, more than those earning in excess of the base amount.

Answer. Under the President's proposals, base broadening will result in a modest increase in social security taxes of about $1½ billion in fiscal year 1987. This modest increase has not been included in tables showing the revenue impact of the proposal, primarily because the proposed reform is of the income tax. However, the arguments in favor of broadening the income tax base apply equally well to the social security tax base: (1) the continual erosion of the base is one of the major causes of the need for increases in social security tax rates; and (2) it is unfair for workers earning essentially the same amount of earnings to pay substantially different amounts of social security tax. Over the long run, therefore, expansion of the social security tax base is most likely to allow lower social security tax rates for middle income persons.

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